OUR BEST IDEAS NEWSLETTER

Valuentum Securities

Stock Analysis: From Value through Momentum Investing

Big News

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Valuentum Securities Inc.
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Upcoming: We're nearing completion of an updated, extensive, backtested study on the Valuentum Buying Index (VBI) rating system that evaluates thousands of individual time series. Years of work compiled…Stay tuned!

The Best Ideas Portfolio (see page 8): AAPL, MO, BRK-B, CSCO, CVS, DG, FB, GM, GOOG, GOOGL, XLV, INTC, JNJ, PYPL, PCLN, SDY, UNP, XLE, XLU, VRNT, V

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"By blindly holding some of the most overheated stocks as they become even more 'bubbly,' indexers may be championing risk more than anything else."

- Brian Nelson, CFA

Goals of the Best Ideas Newsletter:

We want to deliver positive returns, year after year, in addition to outperforming the market benchmark. We may not always be successful, however. Our Best Ideas Newsletter portfolio is generally found on page 8 of each edition.

The Best Ideas Newsletter portfolio is not a real money portfolio. Results are hypothetical and do not represent actual trading. Actual results may differ from performance information being presented.

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Systemic Risk in These Frothy Times

By Brian Nelson, CFA

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For most investors during most parts of the economic cycle, index investing (VOO), or holding a broad basket of stocks that approximate the returns of a large market index may make a lot of sense. I have always said this from the very beginning: Individual stock selection is not for everyone. What may not be well-known, however, is that index funds have experienced multi-year periods of both outperformance *and underperformance* relative to actively-managed funds since the dawning of the very first index fund many decades ago. I'm worried that some investors today may not have this complete story in light of some of the news headlines I have been reading.

What is being widely-disseminated in the news is that the past several years have been quite favorable to those preferring a "passive" approach and relatively less favorable to those seeking a more-active bent. One of the biggest behavioral, or cognitive, pitfalls investors sometimes face, however, is something called recency bias, generally defined as when individuals evaluate the most recent trends to determine what may immediately lie ahead. A big trend in the financial industry, if not the biggest trend, has been the massive flow of funds into "passive" products and out of actively-managed vehicles. This has occurred as a result of a number of factors, with one of them being, of course, the recent underperformance of many active managers relative to index funds.

The move to passive shows no signs of slowing either, and passive products aren't really passive, but that is a topic for another day (i.e. someone manages the index). One may posit, however, that most of the recent underperformance from the actively-managed camp has largely been a result of active managers heeding caution and being prudent in today's frothy market, perhaps steering clear of speculative entities that have largely been leading the broader market higher, stocks such as Netflix (NFLX) or Tesla (TSLA), for example. Are we to blame these active managers for their prudence or instead applaud them? Are we to reward indexers for their aggressive risk-taking or instead take note of indexing's potential

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"). Results are hypothetical and do not represent actual trading. Contact us for more details about how the team utilizes the Valuentum Buying Index to run the portfolio.

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vulnerabilities near market tops? It's certainly debatable, but that's really not what I am getting with this piece.

What I think is most important for readers to remember is that index funds can and have experienced prolonged periods of both outperformance and underperformance. I was recently reminded of a USA Today article from April 16, 2007 ("Great minds don't think alike about index funds," John Waggoner), where John Bogle, founder of the Vanguard Group, openly admitted that over the first five-year period since index funds existed, they "were outperformed by two-thirds of funds." This is the same type of randomness that we are seeing today, but reversed: index funds have outperformed most active managers, after fees, more recently. However, not many in the business seem to be presenting such information in a fair and balanced way, and there may arise a big problem when the loudest and most influential voices are saying that beating the market is not possible. Not possible? It certainly is possible, and over multi-year periods, and right from the words of Vanguard's founder himself.

Investors simply deserve the unbiased truth. As an independent publisher, we're in a unique position to provide such a thing. It will never be up to me to determine what is the best investment path for anybody, but I feel that it is my responsibility that if 'everyone' is repeating a fallacy, I must stand up and speak the truth. I view it as my job. Indexing is not a guaranteed way to retirement freedom, no matter what the past suggests. Index funds can be outperformed by actively-managed funds for sustained periods of time, no matter what anybody says. John Bogle's syllogism that says all active managers underperform index funds after fees is not a correct syllogism of the market, in my view. Here is what I believe to be the correct syllogism that represents the market (I have built a proof, too, to support it). Frankly, I think this is a big deal. Investors and financial advisors all over the planet deserve to know these things, whether they like indexing or not.

1. All investors own the stock market.
2. The aggregate returns of all investors after all fees and expenses do not equal the average returns of all investors after all fees and expenses.
3. In any given year, the probability that the average return of all investors after all fees and expenses will be more or less than the aggregate return is not defined. Each passing year has a unique outcome, independent of the past.
4. The percentage of investors outperforming the index after all fees and expenses can be greater or less than the percentage of investors underperforming the index after all fees and expenses in any given year, every year.

Image shown: Nelson's Syllogism of the Stock Market

But why do I care about a growing portion of the population that is parking their hard-earned money in index funds? To know why, you have to understand how I view index funds, in general. To me, and again, index funds can be the right path for many investors, but to me, they represent "buying everything at any price and holding no matter what," akin to using the rear-view mirror to drive a car with your hands off the wheel. But why do I care so much, and why now? Well, first of all, because the stock market today is trading at very lofty levels relative to historical measures, something we talked extensively about in the June 2017 edition of the Best Ideas Newsletter.

What I am most concerned about is that recency bias may lead investors to believe today that index funds are guaranteed to outperform actively-managed funds going forward, perhaps like active managers may have believed they'd outperform index funds going forward after their successful five-

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year stint following the launch of the first index fund many moons ago. My position will never be pro-active or pro-passive, but right down the middle, straight down the middle. My position is pro-truth, pro-investors and standing up for logical reasoning. Bottom line: I don't want you to be fooled by randomness, and especially I don't want you to be fooled by randomness in today's frothy market, where stocks are trading at elevated multiples. Even the Federal Reserve is chiming in about valuations and the "buildup of risks to financial stability." From their minutes, June 13-14, 2017:

> Corporate earnings growth had been robust; **nevertheless, in the assessment of a few participants, equity prices were high when judged against standard valuation measures.** Longer-term Treasury yields had declined since earlier in the year and remained low. Participants offered various explanations for low bond yields, including the prospect of sluggish longer-term economic growth as well as the elevated level of the Federal Reserve's longer-term asset holdings. Some participants suggested that increased risk tolerance among investors might be contributing to **elevated asset prices more broadly**; a few participants expressed concern that subdued market volatility, coupled with a low equity premium, **could lead to a buildup of risks to financial stability**.

In many ways, our prediction for the stock market "bubble" to continue to inflate in 2017 remains spot on, with major indices setting new highs recently. Our prognostication that President Donald Trump would "trumpet" the market is also coming to fruition, with him tweeting more frequently about record-setting performance in the indices. Here is his latest tweet from July 12: "Stock market hits another high with spirit and enthusiasm so positive. Jobs outlook looking very good! #MAGA." I love that the President is paying attention to the stock market and the wealth of Americans, and I hope that he may even tweet about the risks of stock market investing, too. For one, past results are never a guarantee of future performance, and this applies to indexing, too. Second, I think the financial industry needs an overhaul. I think we need to redefine what cost means to the investor. It goes far beyond the fund expense ratio and should include the price of the underlying constituents of the fund, too. A fund with a 0.00001% expense ratio where its collective holdings are trading at 100000x earnings, for example, certainly can't be considered "low cost," can it?

As it relates to broad-based market valuations, the forward 12-month P/E ratio of the S&P 500 is 17.3 times, as of July 7, according to FactSet, above the 5-year average (15.3) and the 10-year average (14)--meaning the market continues to trade well above historical valuation norms. The cyclically-adjusted price-to-earnings (CAPE) ratio, the market-cap-to-GDP ratio, and anecdotal evidence surrounding the performance of ultra-speculative vehicles further support the view that we are in an overheated market. In some ways, what has made index investing look so good the past few years is that many reasonable investors may have taken profits off the table due to valuation concerns. By blindly holding some of the most overheated stocks as they become even more "bubbly," indexers may be championing risk more than anything else. I firmly believe that if I were not warning investors about the random outcomes of indexing relative to active management and the frothiness of today's stock market, I wouldn't be doing my job. What are other publishers doing, I say?

One more thing about indexing. According to Bank of America, "the proportion of stocks on the main U.S. benchmark equity index now managed passively has nearly doubled since the 2008 crisis to 37 percent while ETF trading accounts for about a quarter of the daily volume across U.S. exchanges." That's a staggering statistic. More than one third of capital in the S&P 500 (SPY) is passively-managed (and this has *nearly doubled* since 2008), meaning that a large and growing part of the market is not paying attention to the price-versus-fair value equation or even working to set stock prices efficiently, particularly if such passive money is long-term oriented ("buy and hold"). I posit that if quantitative investors and algorithmic traders are basing their systems on today's market where more than one third aren't paying attention to the price (or cost) of their investments, then the price-setting mechanism of the market may be starting to break down. Remember, index investors still impact the market price with their buying and selling activity. They are not bystanders, but market participants. I think the proliferation of indexing coupled with quantitative

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models that incorporate indexing's real impact, by definition, pose a meaningful, systematic risk to the health of the stock market.

As we've been saying for some time, however, even as we grow more and more concerned about the stock market, the Best Ideas Newsletter portfolio still has a large number of ideas within it. Many of them have been performing fantastically as of late, too, namely Facebook (FB) and PayPal (PYPL), which have set new highs recently. Top-weighted Visa (V) is trading north of the mid-$90s, and many other ideas have been doing equally well. We continue to be pleased with our value processes at Valuentum (the discounted cash-flow model), but if it weren't for our methodology that lets "winners" run, many ideas in the newsletter portfolio would have been discarded some time ago. We've stated many a time before that value investors can sometimes truncate performance when they sell a stock at "fair value." The Valuentum methodology generally requires a stock to be both overvalued and exhibiting poor technical and momentum indicators before it is removed from the Best Ideas Newsletter portfolio. As author of "A Random Walk Down Wall Street" and indexing proponent, Burton Malkiel, has more recently embraced combining value and momentum can have tremendous benefits. This is something we've been saying for years.

I hope you enjoy the July edition of the Best Ideas Newsletter!

MLP Speak: A Critique of Distributable Cash Flow

By Brian Nelson, CFA

Discuss:

In the handouts, we saw that Energy Transfer Equity's (ETE) distribution is financed from the *financing* section of the cash flow statement ("FINANCING ACTIVITIES"), not from internally generated free cash flow (as traditionally defined as cash flow from operations less *all* capital spending). We call these types of distributions *financially-engineered* payouts.

Because these types of distributions are funded by external market issuance, not by internal means (traditional free cash flow), it stands to reason that the size of these types of distributions may not be a fair representative driver of the "true" intrinsic value of the operating assets of the business. By extension, should distribution yield analysis be used *at all* when valuing MLPs?

Please contact us for presentation handouts.

It's been a few years since the fallout in the prices of most master limited partnerships (AMLP), but to me, it still feels like yesterday. We continue to have many concerns about the longevity of the business models of MLPs, and we maintain our view that the operating structure will be challenged over the long haul.

New equity and debt funding (issuance) continues to, in part, fuel the distributions of most MLPs, and we think it is fair to call most MLP distributions financially engineered. As in almost all MLP cases, traditional free cash flow, as measured by cash flow from operations less all capital expenditures, is less than cash distributions paid, and most MLPs "use" the financing section of the cash flow statement to make up for the shortfall--in essence, issuing new equity or new debt. Hence, most distributions are, in part, financially engineered.

MLP Speak...continued on next page

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The poster child we often use to explain this unique circumstance is Energy Transfer Equity (ETE). Looking at its GAAP financial statements for the six months ended June 30, 2015, for example, the entity generated $1.1 billion in cash flow from operations, but distributed north of $1.6 billion in cash to noncontrolling interests and partners. Meanwhile, capital spending during the half-year was $4.2 billion.

Traditional free cash flow generation was -$3.1 billion (negative $3.1 billion) during that 6-month period, and after accounting for the $1.6 billion shelled out as cash distributions, the cash burn came to -$4.7 billion (negative $4.7 billion). The shortfall was financed by issuing net new debt of $4.1 billion ($15.4 billion in proceeds from borrowings less $11.3 billion in repayments of long-term debt), as well as another $1.8 billion in subsidiary equity offerings.

Has anything really changed since then? Not really. During the three months ended March 31, 2017, for example, traditional free cash flow at Energy Transfer Equity was still decidedly negative, and net cash provided by operating activities ($893 million) fell short of distributions to noncontrolling interests ($752 million) and partners ($251 million), or ~$1 billion. Interestingly, again, the shortfall is made up from ~$800 million in net new borrowings and even more new funds from units issued for cash. New debt and new equity used to pay existing shareholders? That's how some see it.

The problem for the common investor is that he or she is being provided a different metric for MLPs than what is in the GAAP financial statements, and it is often lightyears apart in substance. Looking at the press release accompanying second-quarter 2015 earnings, for example, Energy Transfer Equity raised its quarterly cash distribution by 39% on a year-over-year basis that July 2015, as the company noted that its distribution coverage ratio was 1.2 times during the period (1.2 times!), despite burning through an estimated ~$4.7 billion. There's just something terribly wrong about the measure "distributable cash flow" as a useful metric to investors.

Not only does "distributable cash flow" not reflect the economic reality of cash moving in and out of the business on an net operating basis, but the measure itself houses an imbalance that simply lacks consistency. The reconciliation of net income to adjusted EBITDA and distributable cash flow for most MLPs (see example here) begins with net income but yet, it doesn't include the growth capital spending that is used to propel the very net income included in the "distributable cash flow" calculation in future periods. In many ways, MLPs are getting a free pass on growth capital (as if it were not unitholder money), especially if investors are "valuing" MLPs on the basis of distributable cash flow, or yield. Here's some background from Energy Transfer Equity:

> Distributable Cash Flow and Distributable Cash Flow, as adjusted, are also important non-GAAP financial measures for our limited partners since these indicate to investors whether the Partnership's investments are generating cash flows at a level that can sustain or support an increase in quarterly cash distribution levels. Financial measures such as Distributable Cash Flow and Distributable Cash Flow, as adjusted, are quantitative standards used by the investment community with respect to publicly traded partnerships **because the value of a partnership unit is in part measured by its yield** (which in turn is based on the amount of cash distributions a partnership can pay to a unitholder). The GAAP measure most directly comparable to Distributable Cash Flow, and Distributable Cash Flow, as adjusted, is net income for ETE on a stand-alone basis (the "Parent Company").

The large problem with "valuing" a partnership unit on the basis of yield (see here for more) is that when looking at the GAAP accounting, it becomes clear that an MLP's distributions do not reflect the

*MLP Speak…*continued on next page

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economic reality of the business. In the calculation, "distributable cash flow" ignores growth capital spending, which itself is used to propel future net income, which is a core component of distributable cash flow, per reconciliation. Not only that, but because traditional measures of free cash flow, as measured by cash flow from operations less all capital spending, fall short of distributions paid, and are often negative, for most MLPs, distributable cash flow becomes a near-meaningless metric. Most MLPs are funding traditional free cash flow shortfalls with new equity and debt issuance, and it is clear as day on the GAAP cash flow statement.

But why am I bringing this up *again*? Well, the reason for this piece is not because I am having a bit of nostalgia, but rather because of an article published July 5, "SEC Tells Companies to Be Careful How They Talk About Free Cash Flow." First and foremost, we applaud the SEC's move to caution companies on how they present free cash flow, and we're hoping that we may eventually see a systematic measure of free cash flow as a mandatory release for all companies--hopefully one as simple and straightforward as cash flow from operations less all *gross* capital spending (companies sometimes like to use net capital spending). The transparency and consistency that this one move would make across the financial markets would be phenomenal, and we hope one day we will see this.

That said, in the SEC's May 2016 guidelines for free cash flow, it reads (Question 102.07) in response to a question that defines free cash flow as cash flow from operations…less capital expenditures: "Companies should also avoid inappropriate or potentially misleading inferences about its usefulness. For example, "free cash flow" should not be used in a manner that inappropriately implies that the measure represents the residual cash flow available for **discretionary** expenditures, since many companies have mandatory debt service requirements or other non-discretionary expenditures that are not deducted from the measure." The guidelines make a lot of sense to us.

However, when we think about such guidelines for free cash flow, a punitive metric that deducts for all capital spending, it becomes questionable whether distributable cash flow, because it does not deduct for growth capital spending, is a useful measure at all. After all, the general partner determines a **discretionary** reserve with respect to distributions, *distribution coverage ratios vary quarter-to-quarter and are not fixed at 1*, more than 20 MLPs have opted to cut their distributions since we warned about their business models in mid-2015, and many have chosen to pursue business-model simplification initiatives, rolling up subsidiaries and adjusting their payouts along the way. Yet, distributable cash flow continues to set MLP distribution policy, enabling "yield," which then may drive equity "valuations," something that we believe contributed to the bubble in early 2015 (see here on how traditional enterprise valuation can be used to value MLPs).

The bottom line: If traditional free cash flow should not be viewed as a measure representing "the residual cash flow available for discretionary expenditures," including dividend policy (which is discretionary), some may reason that distributable cash flow should probably not be used either to set MLP distribution policy, itself discretionary to a large degree. It is our view that only when debt and equity funding becomes more prohibitive in the face of rising interest rates or tumbling energy resource prices will we see (again) just how much MLPs depend on the healthy functioning of the capital markets to fund their distributions--and how little "distributable cash flow" reflects the underlying "value" of the MLP business model.

Walgreens Builds Out Its Network

Walgreens continues its quest to build out its network of pharmacies. The goal is to maintain the largest network in the US, which would make exclusion from a payer's network very difficult. Let's review the recently-revised terms of the deal to acquire a portion of Rite Aid, the third-largest pharmacy chain in the US.

By Alexander J. Poulos

The Quest to Expand the Network

Walgreens Boots Alliance (WBA), under the very capable leadership of Stefano Pessina, is attempting to transform into a global pharmacy-led health and wellbeing provider. The genesis of the idea was initiated with the combination of Boots Alliance, a predominately UK-based pharmacy chain with Walgreens. Upon the consummation of the deal in 2014, Walgreens significantly expanded its global reach.

Pessina is not satisfied with merely a global presence--the goal is to enhance profitability by severely trimming operating costs. Pessina had teamed up with legendary private equity firm Kohlberg Kravis Roberts to merger Alliance Unichem with Boots Group PLC to form Boots Alliance. The transaction led to the combined entity going private with a large debt load. Pessina masterfully reduced costs while increasing sales--the payoff came when Walgreens agreed to purchase Boots Alliance with Pessina ascending to the role of CEO of the combined entity.

The rewards were enormous for Pessina--he became a billionaire. For KKR, the buyout led to a tripling of its initial investment. KKR, post the merger, retained an equity stake in Walgreens, which it has subsequently divested. We remain impressed with the deep knowledge of the industry possessed by Pessina, and we continue to view his leadership as "visionary." With the bulk of his fortune tied to the performance of Walgreens, we feel he is properly incentivized to lead to the company.

Filling out Walgreens Reach in the US

As it stands now, Walgreens' coverage map has a noticeable deficiency in the Northeast, as the region is primarily dominated by its arch-rival CVS Health (CVS) and the third largest player in the industry--the beleaguered Rite Aid (RAD). The map below shows Rite Aid's footprint.

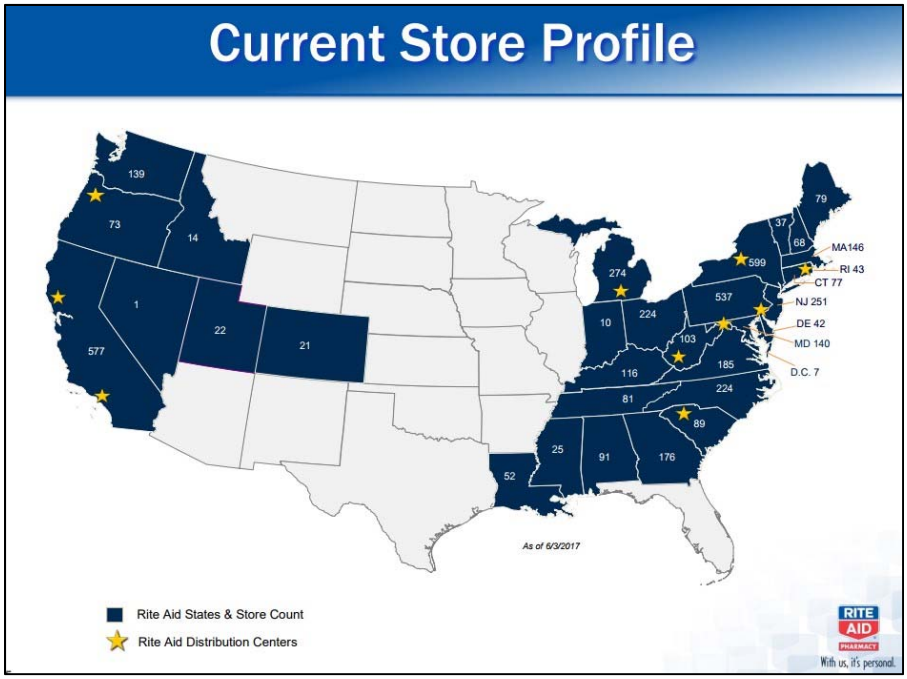

Image Source: Rite Aid

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Big News

Upcoming: We're nearing completion of an updated, extensive, backtested study on the Valuentum Buying Index (VBI) rating system that evaluates thousands of individual time series. Years of work compiled…Stay tuned!

Best Ideas Doing Well!

By Valuentum Analysts

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 ~25% of the portfolio in cash, a reasonable level, in our view, given the current market environment. 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. The goal of the Best Ideas portfolio is to outperform the S&P 500 Index and to generate positive returns each year regardless of the market environment. We may not always be successful, however.

SIMULATED BEST IDEAS PORTFOLIO -- as of July 15, 2017 — **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	5	$165.00	0.90	17-Jun-11	51.92	107	5,569.33	149.04	15,947.28	1,279.22	6.9%	209.3%
Altria Group	MO	8	3	$60.00	1.23	28-Jun-11	28.39	157	4,471.86	73.93	11,607.01	2,667.10	5.0%	219.2%
Berkshire Hathaway	BRK-B	6	6	$173.00	0.98	20-Apr-16	146.13	69	10,089.97	169.51	11,696.19		5.0%	15.9%
Cisco	CSCO	9	7	$42.00	0.75	14-Nov-14	26.33	221	5,831.87	31.42	6,943.82	461.02	3.0%	27.0%
CVS Health	CVS	9	6	$104.00	0.75	6-Jan-17	81.84	79	6,472.36	77.93	6,156.47	79.00	2.7%	-3.7%
Dollar General	DG	4	4	$75.00	0.95	13-Apr-17	68.83	50	3,448.50	71.14	3,557.00	13.00	1.5%	3.5%
Energy Select SPDR	XLE	NR	NR	NA	NMF	6-Oct-15	67.14	143	9,608.02	65.40	9,352.20	444.92	4.0%	2.0%
Facebook	FB	6	5	$187.00	0.86	29-Jan-16	112.10	50	5,612.00	159.97	7,998.50		3.4%	42.5%
General Motors	GM	6	6	$43.00	0.85	26-Aug-16	31.65	132	4,184.80	36.35	4,798.20	150.48	2.1%	18.3%
Google - Class C	GOOG	10	7	$995.00	0.96	23-Oct-12	450.92	7	3,170.42	955.99	6,691.93	10.35	2.9%	111.4%
Google - Class A	GOOGL	10	7	$995.00	0.96	4-Apr-14	Split	7	Split	976.91	6,838.37		2.9%	+++
Health Care ETF	XLV	NR	NR	NA	NMF	22-May-12	36.60	125	4,582.00	80.12	10,015.00	602.36	4.3%	131.7%
Intel	INTC	6	7	$42.00	0.83	12-Sep-11	20.48	150	3,086.50	34.68	5,202.00	714.45	2.2%	91.7%
Johnson & Johnson	JNJ	6	7	$121.00	1.10	29-Jan-16	104.18	54	5,632.72	132.60	7,160.40	258.66	3.1%	31.7%
PayPal	PYPL	NR	6	$51.00	1.12	17-Jul-15	Spin-off	100	Splt	57.16	5,716.00		2.5%	+++
Priceline	PCLN	10	6	$1705.00	1.14	26-Feb-15	1239.49	6	7,450.91	1950.87	11,705.22		5.0%	57.1%
SPDR S&P Dividend ETF	SDY	NR	NR	NA	NMF	20-Apr-16	81.33	124	10,091.92	89.35	11,079.40	314.89	4.8%	12.9%
Union Pacific	UNP	6	3	$100.00	1.10	24-Jul-13	79.67	40	3,193.80	109.53	4,381.20	312.60	1.9%	47.0%
Utilities Select SPDR	XLU	NR	NR	NA	NMF	18-Mar-14	41.12	83	3,419.96	51.92	4,309.36	435.24	1.9%	38.7%
Verint Systems	VRNT	6	3	$50.00	0.81	13-Apr-17	38.95	87	3,395.65	40.55	3,527.85		1.9%	3.9%
Visa	V	7	5	$84.00	1.15	30-Nov-11	26.86	188	5,064.39	96.93	18,222.84	424.73	7.8%	268.2%
NFLX put option contracts, Aug expiration, $125 strike								5	772.00	52.00	260.00		0.1%	
SPY put option contracts, Aug expiration, $237 strike								2	1,099.00	68.00	136.00		0.1%	
Latest changes: Removed BWLD (6/20).														
Cash -- changes in monthly cash balance reflects dividends received and trading gains/losses, where applicable.											58,956.46		25.4%	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 -->	**232,258.70**			**132.3%**
S&P 500 Index (SPY)						17-May-11	132.69	754	100,000.00	245.51	185,025.25	17,540.46	91.3%	
Cash											17,540.46		8.7%	
Benchmark Portfolio Value											**202,565.71**			**102.6%**
Relative Outperformance														**29.7 pts**

Data as of July 15, 2017. The cost basis of positions includes commissions. The Best Ideas Newsletter portfolio's performance includes dividends received, but not interest received on cash balances. The Best Ideas Newsletter portfolio is not a real money portfolio. The 'Benchmark Portfolio Value' reflects dividends received and held as cash.

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

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

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Walgreens...from page 7

A quick overview of Rite Aid is warranted to give an overview behind the motivation to sell on Rite Aid's part. Rite Aid has yet to recover from the disastrous leadership of Martin Grass, in our view. The first cracks in the accounting fraud undertaken by Grass began to reveal themselves in the autumn of 1999 when Rite Aid shocked the Street by stating the accounting numbers issued by Grass should not be relied upon. Grass had embarked on an ambitious acquisition spree that saddled the company with an enormous debt load.

The result of the ordeal led to Grass being sentenced to eight years in prison. Rite Aid has staved off bankruptcy by selling off pieces of itself yet what remains is a barely profitable pharmacy chain saddled with an enormous debt load and a sub-$10 dollar share price.

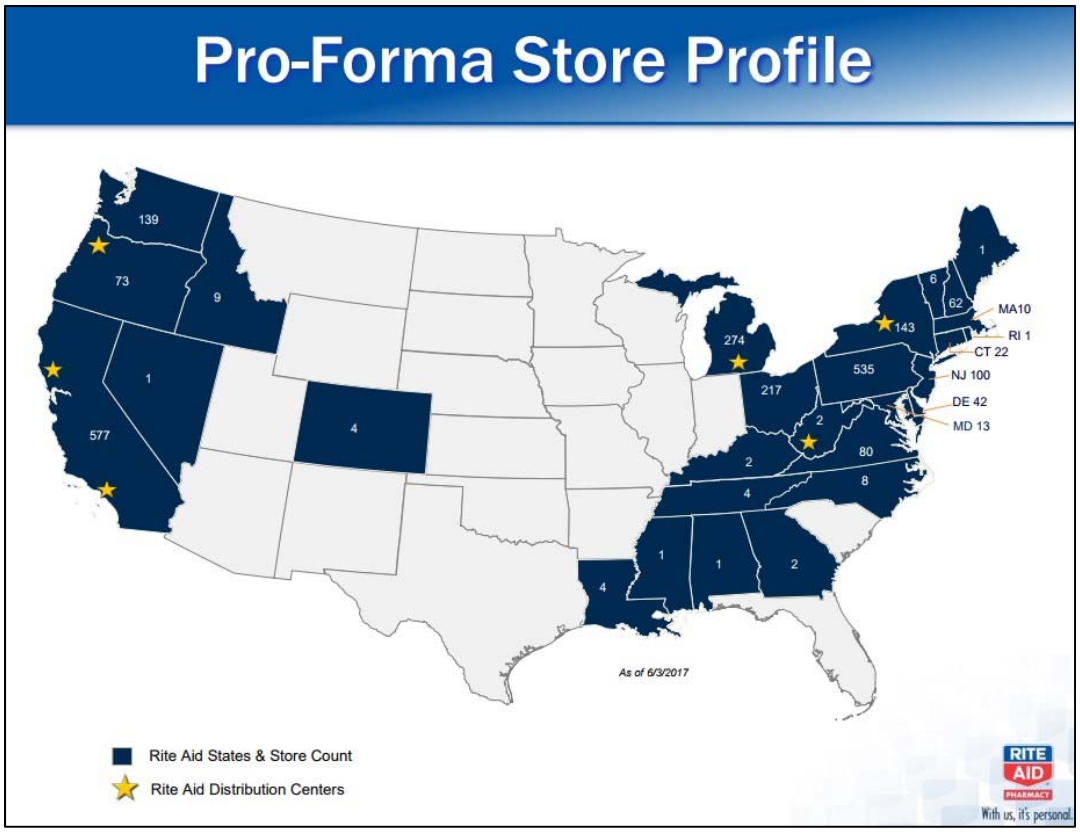

Image Source: Rite Aid

We believe Rite Aid does hold some value for a strategic buyer due to its significant presence on the Eastern seaboard of the US. Due to its dense cluster of stores in the northeast, CVS would likely be unable to make an attempt to purchase Rite Aid in its entirety on antitrust grounds. The market share concentration would be far higher than the government would be comfortable with, from our perspective. We had also been skeptical the ambitious purchase of Rite Aid by Walgreens would be allowed to go through as Walgreens' market share in certain markets would also become problematic. Walgreens agreed to divest a significant amount of stores, yet clearance remained elusive.

A New Deal Emerges

That said, we are very pleased to see a new deal struck June 29 that would net Walgreens a boost to its market share in the northeast US, and that the agreement is structured in a way such that it would

Walgreens...continued on next page

Walgreens...from previous page

pass an antitrust review. Walgreens has agreed to purchase 2,186 stores from Rite Aid along with four distribution centers for $5.175 billion dollars. Rite Aid is also entitled to a break-up fee of $325 million for the termination of the original deal.

The bond holders of Rite Aid rejoiced on the news as the cash infusion will significantly aid the balance sheet. We would like to highlight a little-mentioned tidbit of the deal that has widespread implications for Rite Aid as a going concern. As part of the deal, Rite Aid will be able to purchase generic drugs at virtually the same cost as Walgreens. In essence as a side effect of the transaction, Rite Aid's buying power is on par with Walgreens', a significant strategic advantage.

Transforming Walgreens

From a strategic perspective, the deal significantly augments Walgreens' market share in the northeast US. The importance of gaining access to real estate in the northeast cannot be understated, in our view; with the continued consolidation in the health care insurance sector, a few well-capitalized national companies are emerging, too. The payers control costs by setting up a network of preferred providers. With the escalating cost of healthcare, consumers often feel they have no choice but to utilize the in-network providers to keep costs under control. The Affordable Care Act paved the wave for payers to institute a restricted network in the name of reigning in health care costs.

With the Rite Aid transaction, Walgreens is aiming to bolster its ~20.5% retail pharmacy market share. Outside from the apparent market share gains, the transaction should augment Walgreens' bargaining clout with payers. Walgreens can now state it has significantly bolstered its overall network, thus making exclusion very difficult.

For the 2012 plan year, Express Scripts (ESRX) made an attempt to reign in drug costs by excluding Walgreens from its nationwide network. The argument made was Walgreens demanded a premium over what other pharmacies received as a reimbursement for services. Express Scripts mentioned the premium in some instances could exceed 20%. Both parties engaged in a protracted battle with the decision made to allow Walgreens access once again. While terms of the deal are confidential, a similar conflict has yet to emerge since, leading us to conclude Walgreens' expansive network has far more staying power than Express Scripts realized.

The Amazon Threat

As detailed in a recent post "Opinion: Is Amazon Prepared to Tackle the Pharmacy Market?" we discussed our view of the Amazon (AMZN) threat on the retail pharmacy market. We concluded the next move for Amazon is to build out its own internal pharmaceutical benefit management (PBM) unit before entering the market, if it so chooses. We continue to feel the most likely outcome is an Amazon PBM not Amazon popping up drugstores at every corner. We are pleased to report Pessina echoes our views.

> *"I don't believe that Amazon will be interested in the near future, in the next few years in this market because they have so many opportunities around the world and in many other categories, which are much, much simpler than health care, which is a very regulated business. And also it's a business, which -- where -- an industry where the consolidation has been really quite significative. So there are not a lot of new things that they could do. Of course, they could, but not so many as they could do in other markets. So as they are a very good team and very rational team, I believe that at the end, this will be -- will not be their priority. Having said so, if we were wrong and our belief was wrong, I believe that at the end of the day, we could find our role in the new environment. We wouldn't exclude to partner with them."*

Walgreens...continued on next page

*Walgreens...*from previous page

We found the last sentence the most compelling. A partnership with Amazon would be exciting. We could easily envision a scenario where Amazon provides PBM services with Walgreens on the other end offering fulfillment in addition to other clinical duties.

Conclusion

We are big fans of the new WBA-RAD deal, as we feel it addresses the deficiencies in Walgreens' network. The share price of Walgreens, however, remains locked in a near two-year sideways trading pattern with a recent breakdown post the Amazon announcement of its intention to purchase Whole Foods (WFC). We will continue to monitor the dynamics of the pharmacy industry closely—especially the plight of Best Ideas portfolio member CVS Health. Stay tuned for ongoing updates.

Healthcare and biotech contributor Alexander J. Poulos is long CVS Health.

Analyzing the S&P SPDR Biotech ETF

ETFs are rapidly becoming the preferred investment vehicle to gain broad exposure to a particular sector. The biotech industry is no different with two distinct ETFs dominating the niche. The article discusses the unique characteristics of the SPDR Biotech ETF to determine the merits of the idea.

By Alexander J. Poulos

Introducing the S&P Spider Biotech ETF

The SPDR S&P Biotech ETF (XBI) is a position weighted index with the top 10 components accounting for less than 25% of the overall assets of the index (see image below). The XBI differs sharply from its primary rival the iShares Nasdaq Biotech Index ETF (IBB) which is market-cap weighted with industry stalwarts such as Amgen (AMGN) accounting for over 8% of the portfolio. The iShares ETF runs a concentrated portfolio of large cap biotech entities, with the top ten holdings accounting for over 58% of all assets in the ETF (holdings not shown).

Top Ten Holdings of the SPDR S&P Biotech ETF (XBI)

Company	Weight	Market Cap ($ in Millions)
Clovis Oncology (CLVS)	2.93%	$4,517
Exelis Inc (EXEL)	2.44%	$7,196
Kite Pharma Inc. (KITE)	2.25%	$5,864
Alexion Pharmaceuticals (ALXN)	2.19%	$27,192
Alnylam Pharmaceuticals (ALNY)	2.18%	$7,591
Celgene Corp (CELG)	2.13%	$103,029
Sarepta Therapeutics (SRPT)	2.07%	$1,871
Exact Sciences (EXAS)	2.06%	$4,257
Gilead Sciences (GILD)	2.05%	$90,791
Bioverativ Inc. (BIVV)	2.05%	$6,622

Source: S&P SPDR Biotech ETF (XBI)

Upon first glance, outside of industry heavyweights Celgene (CELG) and Gilead Sciences (GILD), the top ten holdings in the SPDR S&P Biotech ETF (XBI) consists of an eclectic mix of exciting late stage companies. These late stage companies sometimes offer the greatest upside potential, but the

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upside is frequently tempered with an elevated level of risk. To pare overall firm-specific risk, however, we feel the structure of the XBI allows for broad exposure to a large basket of biotech equities without necessarily an excessive amount of exposure to the risks of any one biotech's potential pipeline disappointments, a scenario that is all too familiar in the space and can result in wild swings in equity prices, particularly among small cap companies. Let's examine some the top ten holdings of the the SPDR S&P Biotech ETF (XBI) further to gain a better understanding for the ETF.

Top XBI Holding Clovis Oncology (CLVS)

Clovis Oncology is a late-stage company with a focus in oncology. A bit of history is necessary to underscore the risky nature of drug discovery. Early investors in Clovis were severely burned in late 2015 when its clinical studies of breakthrough therapy-tagged Rociletinib in EGFR T790M+ lung cancer failed to gain approval from the FDA. Expectations were running high with shares trading comfortably above $100 when the first signs of non-efficacy began to assert themselves.

Clovis, however, decided to terminate ongoing studies, and the focus was thrust onto its other promising molecule, the PARP inhibitor Rucarapib. A product designated as a breakthrough therapy by the FDA failing to obtain marketing approval remains a rare event, but it is clearly not out of the realm of possibilities.

In what must have been a relief for long-term Clovis bulls, the FDA has granted marketing approval for Rucarapib under the trade name Rubraca. Rubraca is the third entry into the field, but we feel the potential of the class is vast as additional combination therapies to pair with PD-1's are necessary. The overall response rate (ORR) utilizing a PD-1 as monotherapy is less than 20% outside of Renal Cell Cancer (RCC) and Melanoma.

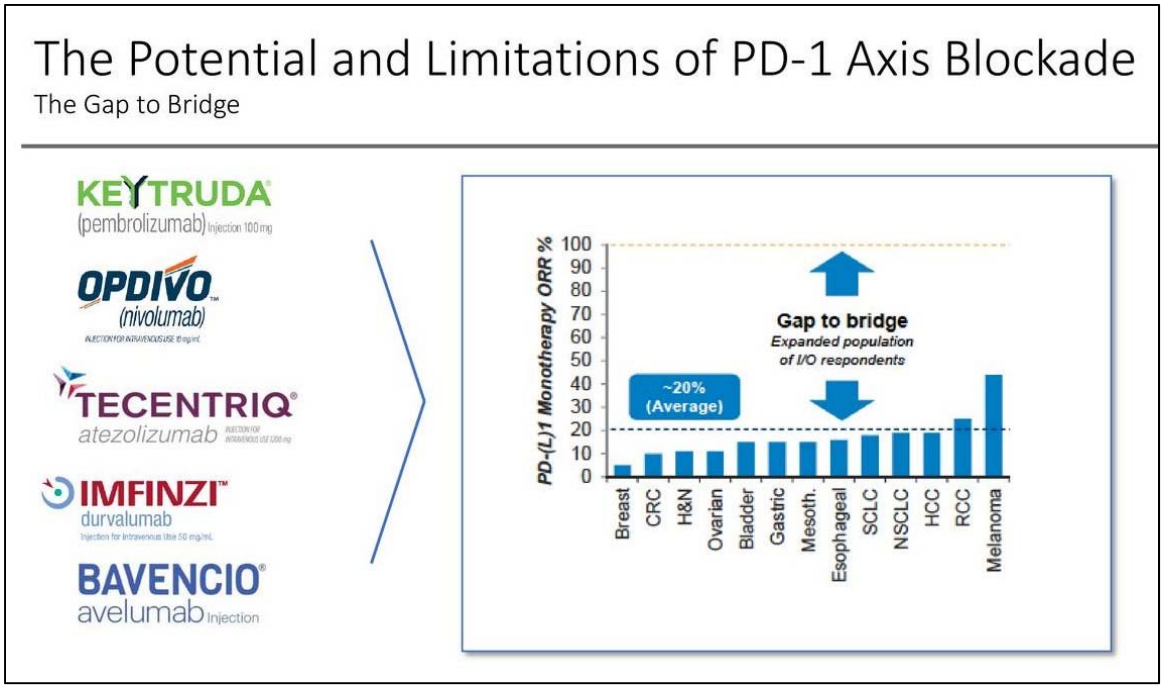

Image Source: Incyte ASCO Investor Presentation June 2017

We feel Clovis has a viable product but additional trials are necessary for multiple indications that will ultimately determine the overall sales potential of the product. Clovis has wisely used the euphoria over the clinical win to enter the market with a secondary share offer to raise funds to use for additional clinical trials. We are watching events as they develop at Clovis--stay tuned for updates.

*Analyzing the S&P…*continued on next page

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Top 10 XBI Holding Sarepta Therapeutics (SRPT)

Sarepta Therapeutics has a bit of a checkered history that is worth examining. Its lead product is EXONDYS 51 a treatment for Duchenne Muscular Dystrophy (DMD). Duchenne's is an inherited genetic disorder where the body lacks dystrophin, a key component that allows muscles to remain intact. Symptoms begin to develop at the age of three with an ultimate life expectancy in the mid-teens. The primary areas affected are the arms and thighs making everyday activities such as climbing stairs or raising your hand complicated. Patients afflicted with DMD often become confined to a wheelchair.

As part of the clinical trials process, Sarepta began testing the product on children afflicted with DMD. Parents felt their children made significant improvements but the FDA deemed the results inconclusive. An aggressive lobbying campaign began with multiple state and Senate representatives voicing their support for the parents of the children afflicted with DMD. The issue was the lack of viable alternatives--the parents believe they should have been granted access to hopefully stave off symptoms as long as possible. The FDA finally relented, and the product was approved for use in September 2016.

In our view, the most appealing late stage biotechs are those that have a large addressable market or a key niche with limited competition. An example of a large addressable market with limited competition is Regeneron Pharmaceuticals' (REGN) recently approved (May 2017) product Dupixent for atopic dermatitis. The atopic dermatitis market looks to be a large, well-defined patient population with little in the way of competition, and shares of Regeneron are beginning to reflect the promise of Dupixent.

EXONDYS 51 falls into the category of a well-defined niche product with an absence of competition. Thus far, uptake remains challenging as payers initially balked at covering the product. Some feel the product is an "elegant placebo"--hence they are reluctant to authorize lofty rare drug prices for the product as drug prices remain a hot button issue in the US. Though the breaking of barriers to improved uptake may be an ongoing battle, if more positive data regarding the efficacy of the drug becomes available, EXONDYS 51 has material potential as a viable commercial product.

Conclusion

Biotech-related ETFs, especially either the XBI or IBB, may be an interesting way to gain exposure to the true innovators in medicine without taking on the risks associated with any one company's potential pipeline disappointments. In our view, the iShares Nasdaq Biotech Index ETF (IBB), with its aggressive allotment to the large cap well-established biotechs can be viewed as a more conservative play on the sector (it does have some firm-specific concentration risk at the top, however), while those that may wish to gain exposure to smaller companies that are relatively more sensitive (in terms of both upside and downside) to the outcome of any one clinical trial, the SPDR S&P Biotech ETF (XBI) may be a more appealing consideration.

Disclosures: Healthcare and biotech contributor Alexander J. Poulos is long Regeneron, Bioverativ and the XBI.

Loxo Oncology Presents Compelling Data on Its TRK Inhibitors

The field of oncology remains an area of intense focus with a dire need for new novel therapies. Loxo Oncology generated lots of excitement with the release of its clinical data for Larotrectinib, a TRK-inhibitor for the treatment of a diverse number of tumors.

By Alexander J. Poulos

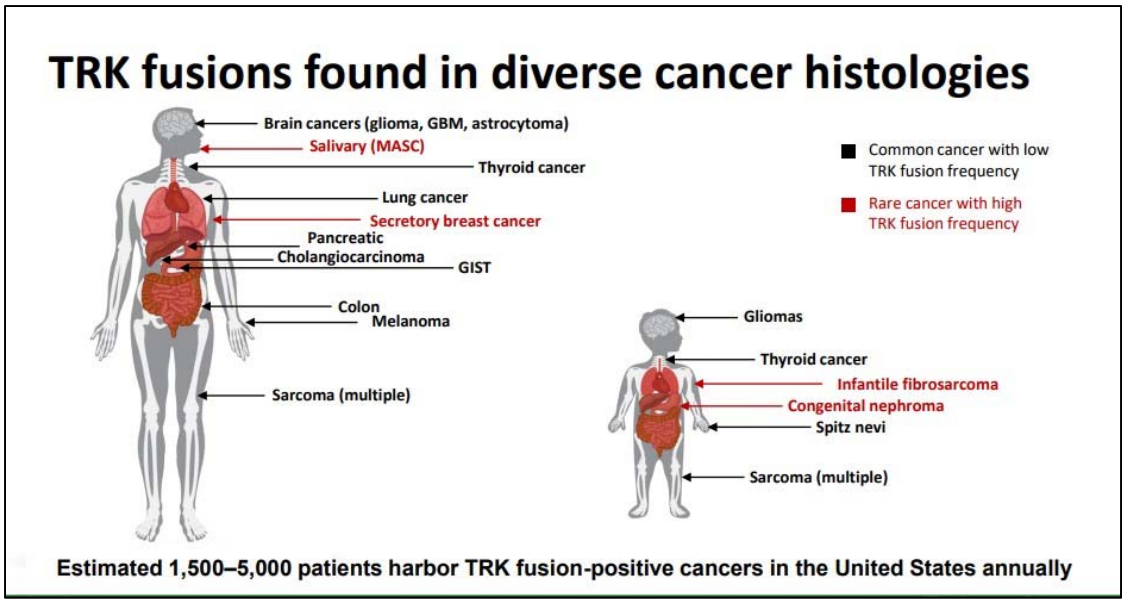

Image Source: Loxo Oncology

TRK Fusion

Loxo Oncology (LOXO) is targeting new therapies that take aim at the tropomyosin receptor kinase (TRK) gene abnormalities that lead to TRK-fusion cancers. A defective TRK gene can fuse with another otherwise healthy gene resulting in abnormal growth. The newly fused cell will continue to grow leading to tumor growth.The abnormal TRK fusion gene is witnessed in a wide swath of tumors--genetic testing can help identify eligible patients for therapy.

Larotrectinib

Loxo's lead product is Larotrectinib, a highly selective pan-TRK inhibitor that can treat a wide swath of ailments. We are initially attracted to the large overall addressable market--Loxo estimates between 1.5-5k patients can be treated annually. Adding to the appeal of the product in our view is the potential use in a pediatric setting. Pediatric cancer remains an area of high unmet need--from a humanitarian perspective, nothing tugs at the heartstrings more than seeing a young child afflicted with a form of cancer. From a marketing perspective, the payers are particularly sensitive to any criticism pertaining to denying care based on the cost of therapy for children. If Larotrectinib is proven effective with a favorable side effect profile, the product will likely become widely used, in our view.

Clinical Trials

We are very pleased with the overall response rate produced by Larotrectinib. The molecule showed an overall response of 76% with 12% of those demonstrating a complete response. The graphic above is a measurement of the shrinking in the size of the tumor over the course of the entire clinical trials. The vast majority witnessed a decrease of over 50% of the overall tumor size—a notable treatment success. While the data is impressive, the side effect profile is critical. If the compound is toxic (an abundance of Grade 3-4 Adverse events), it will limit the commercial potential especially in the use of children.

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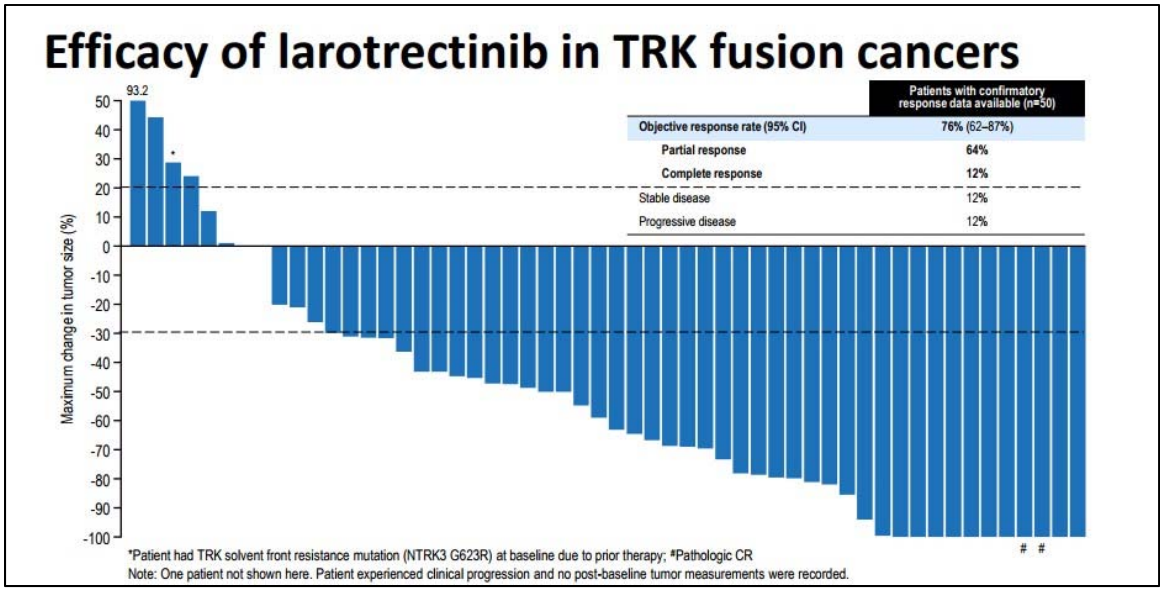
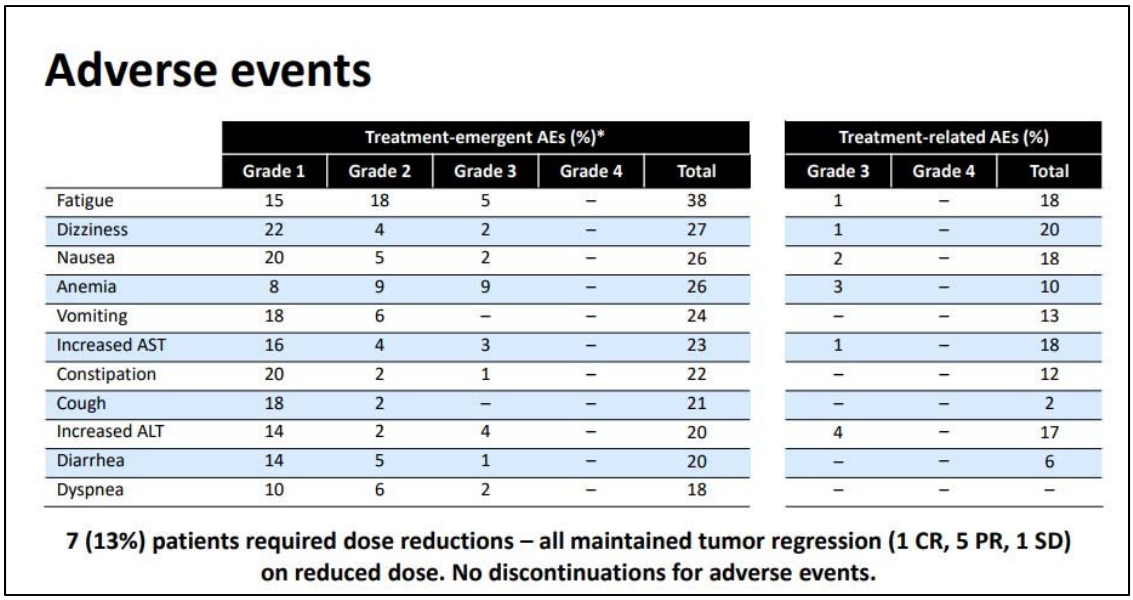


Image Source: Loxo Oncology

Side Effect Profile



Adverse events

	Treatment-emergent AEs (%)*					Treatment-related AEs (%)		
	Grade 1	Grade 2	Grade 3	Grade 4	Total	Grade 3	Grade 4	Total
Fatigue	15	18	5	–	38	1	–	18
Dizziness	22	4	2	–	27	1	–	20
Nausea	20	5	2	–	26	2	–	18
Anemia	8	9	9	–	26	3	–	10
Vomiting	18	6	–	–	24	–	–	13
Increased AST	16	4	3	–	23	1	–	18
Constipation	20	2	1	–	22	–	–	12
Cough	18	2	–	–	21	–	–	2
Increased ALT	14	2	4	–	20	4	–	17
Diarrhea	14	5	1	–	20	–	–	6
Dyspnea	10	6	2	–	18	–	–	–

7 (13%) patients required dose reductions – all maintained tumor regression (1 CR, 5 PR, 1 SD) on reduced dose. No discontinuations for adverse events.

Image Source: Loxo Oncology

However, the side-effect profile remains very benign, too, which heightens the potential in the pediatric patient population. The most common Grade 3 adverse events are anemia and fatigue which is more often a byproduct of tumor growth. Given the information we have at this time, we are reasonably confident an experienced professional will likely have no problem mitigating the side effects.

Larotrectinib shows particular promise as a well-tolerated highly selective treatment. We remain intrigued by targeted therapies, especially those that target a specific genetic abnormality. We feel as the science progresses, additional targeted therapies will emerge that will hopefully have a more benign side-effect profile. Treatments with a favorable side effect profile will be favored by patients and payers alike as the overall cost of therapy should be less than with non-selective therapies. Part of the equation is the cost involved with managing side effects which needs to be taken into account.

Loxo Oncology...continued on next page

*Loxo Oncology…*from previous page

Patent Estate

For biotech firms, especially late-stage entities such as Loxo, the patent estate is critical. Based on our research, the patent for Larotrectinib appears protected until 2029, giving Loxo a long runway to commercialize the product, in our view. The product is licensed from Array Biopharma (ARRY), we have looked at the disclosure from both companies' respective 10-Ks:

> *Our patent portfolio includes patents and patent applications we exclusively licensed from Array, as well as exclusive worldwide licenses for all therapeutic indications for new intellectual property developed in our Loxo/Array discovery programs. This patent portfolio includes issued patents and pending patent applications covering compositions of matter, methods of use, methods of making, and synthetic intermediates.*
>
> *Larotrectinib's patent portfolio includes patents exclusively licensed to us by Array for our product candidates on a worldwide basis for all therapeutic indications. Composition of matter patents for larotrectinib is/are issued in the U.S., Hong Kong, New Zealand, Australia, Bosnia, Chile, Gulf Cooperation Council ("GCC"), Indonesia, China, Columbia, Japan, Russia, Taiwan, Ukraine, the Philippines, and Europe (which has been validated in all member and extension states). The issued U.S. and European patents expire in 2029, not taking into account any applicable extensions for patent office and/or regulatory delay in the relevant jurisdictions*
>
> *Source: Loxo 10-K*
>
> *Array receives advance payments for the preclinical research and other services that Array is providing during the term of the discovery program. To date, we have earned $2.0 million in milestone and other upfront payments and have the potential to earn up to approximately (i) $221 million with respect to products related to TRK, including LOXO-101 (Larotrectinib) and its backup compounds, and (ii) $213 million with respect to product candidates directed to targets other than TRK, if Loxo achieves additional clinical, regulatory and sales milestones plus royalties on sales of any resulting drugs.*
>
> *Source: Array Biopharma 10-K*

From our view, Array is not entitled to ongoing royalties outside of initial milestone payments. Loxo's patent estate seems solid which bodes well for future sales and ultimate profitability.

Conclusion

Loxo Oncology is a highly speculative pre-revenue company with a focus on bringing forth additional novel oncology treatments. The initial data release is very promising, but a significant amount of risk remains, not the least of which is the complete loss of all principle if future endeavors do not pan out. Speculative biotechs are not for everyone, but we wanted to at least get this one on your radar.

Disclosures: Alexander J. Poulos is long Loxo Oncology and S&P Spiders Biotech Index (XBI).

Don't Just Look at the House; Examine the Foundation

By Kris Rosemann and Brian Nelson, CFA

One of the biggest benefits of being a member of Valuentum's investment services is that we show you all of the numbers – the numbers tell the real story.

An author/analyst may tell the story of a company through his/her eyes, but the author/analyst must still convert his/her thoughts and qualitative considerations into quantitative future forecasts to arrive at a fair value estimate of a stock. These future forecasts ultimately determine an intrinsic value estimate of the equity. Without an in-depth valuation process on the basis of future free cash flows, stock analysis is a story that has no end…no tangible conclusion, in our view.

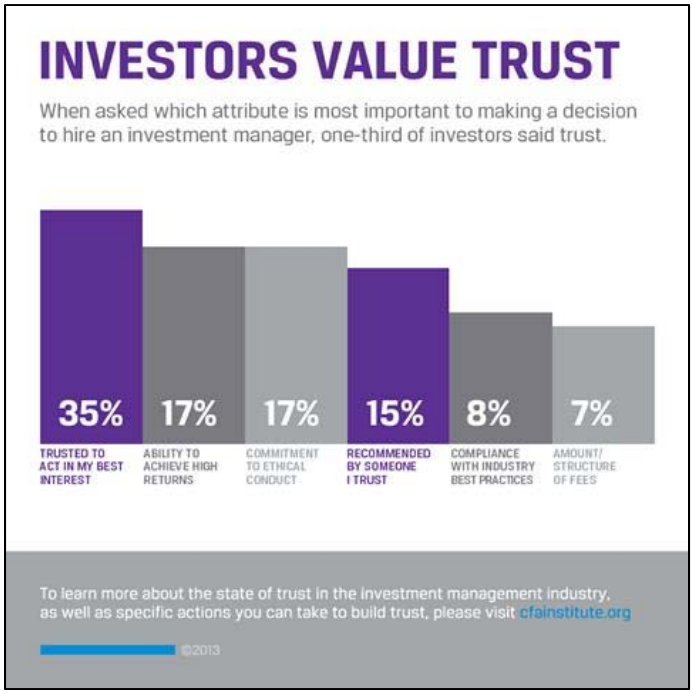
Sometimes readers may not want to see all of data (at times, it can be overwhelming), but we think it's important that investors know it's here at Valuentum. Investors are learning that most of the articles found on the web today do not have a robust cash-flow valuation process – or any robust and systematically-reviewed valuation process – supporting the conclusions.

Buying a stock after reading an article without examining its valuation model is like buying a house without examining the foundation. The house may look pretty on the outside, but there's really nothing supporting it. You may get lucky and be on sturdy ground, or you may not. Just like we don't want our house to sink, we don't want our stocks to collapse either.

You can find our earnings estimates and the hundreds of assumptions we include to arrive at a fair value estimate in our 16-page reports, or if you want to take a fully-populated discounted cash-flow model for a test drive, we make this unique feature available through our Financial Advisor plan (upgrade here). You can use the same models our analyst team uses!

Why are we writing this article?

We're writing this article to show you just how transparent we are as a research publisher (we think this is a good thing) and why we do the things we do. A recent study by the CFA Institute revealed that trust is far and away the most important consideration for an investment service, and we hear you. We don't take our responsibilities lightly.



Source: http://www.cfainstitute.org/learning/future/about/pages/investor_trust_study.aspx

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That said, the best place to start with how we think about forecasts is with a statement that may shock you: There are roughly 40 analysts deriving Google's, now Alphabet's (GOOG, GOOGL) earnings estimates for this year alone. And the large number of analysts isn't a phenomenon unique to Alphabet or just large companies – it's like this for almost every mid/large cap. F5 (FFIV), for example, has nearly 30. Some of the analysts will be right some of the time, and some of the analysts will be wrong some of the time. It's just the way the stock-research business works. No analyst is right all of the time.

But that shouldn't be the takeaway from this article. Investors already know analysts are not perfect (that's why there are earnings beats and misses all the time). Still, we think it is quite informative to examine where these analysts are focusing their attention. Below, please find a snapshot of the earnings-estimate distribution from these analysts, courtesy of FactSet (as of October 2013).

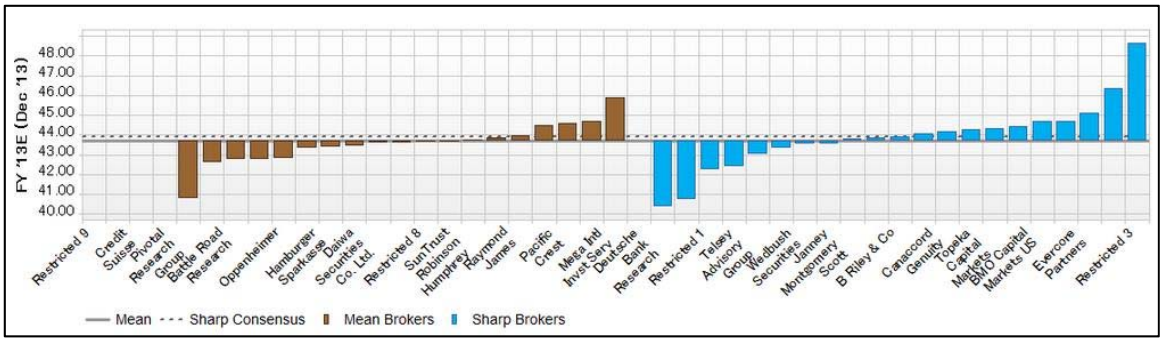

Image Source: FactSet

At the time this article was originally written, you'll see some research firms are pessimistic about the year's earnings estimate of Alphabet relative to consensus and some firms are optimistic. The range of earnings estimates is $41-$48 per share for fiscal year 2013 (at the time, our forecast was $44 per share). More than 40 analysts are all looking at the year's performance and making an estimate.

Are we interested in competing with 40 other analysis on this year's numbers? No. First of all, we don't think we could do a better job than these 40 analysts collectively – just like we don't think we could beat out the ultra-fast algorithmic traders – nor do we want to. Believe us -- we make earnings estimates. We've been in the ballpark at times, and we've been wrong at times. But we can tell you with certainty – next year's earnings have little influence on estimating the "true" long-term intrinsic value of a stock.

Most money managers will try to find an analyst that they think is good – one that predicts earnings surprises or is a good fit for their strategy (think growth, value, momentum). Though there is value to this, we're more interested in getting our fair value estimates "correct" and delivering information regarding the Valuentum Buying Index rating that we think helps to identify future stock price movements. As we outline in the "16 Most Important Steps to Understand the Stock Market", "playing games" with earnings estimates is not the driver behind long-term stock prices (logically, it doesn't make sense):

> Let's ask ourselves these two questions: What if a company continues to miss earnings expectations every quarter into infinity? Will its stock price keep going down forever until it reaches 0? The answer simply is no. Stock prices are determined by expectations of future earnings and cash flow. A company will still have value even if it continues to miss earnings. Consensus estimates and even whisper numbers move around often. And I've even heard of some speculation that some analysts actually raise their target prices and lower earnings estimates (at the same time for the same company), so that specific company can beat estimates (and hopefully traders drive the stock price higher to their target price, so they look smart). This can't be true, right? Well-seasoned market participants may know about this potential conflict and what I am talking about.

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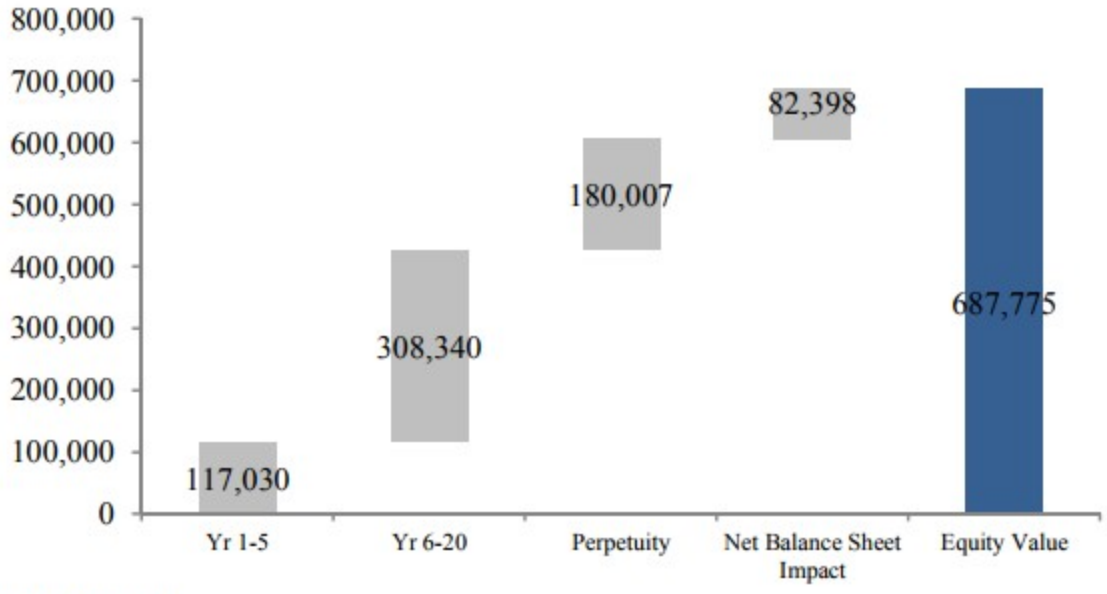
Simply put, we just don't see much value in spending our time competing with 40 other analysts (on Alphabet alone), where a lot of them will be wrong. Therefore, within our discounted cash-flow valuation models, our top- and bottom-line forecasts for the next two years, do not vary much from consensus estimates or management's provided guidance. Where we do differentiate ourselves is in the intermediate- and long-term forecasts that are more important to the derivation of a fair value estimate, in our view.

Please examine the distribution of a company's equity value, per Alphabet's 16-page report from May 2017 below. Roughly $117 billion (17%) of the company's equity value comes from value generated during the next five years, $308.3 billion (45%) from years 6-20, $77.2 billion (26%) from perpetuity, and the balance from its balance sheet position. For a company such as Alphabet, one that generates gobs of free cash flow annually, a long-term focus has even more credence. We believe ignoring the analysis of the composition of value generated outside of the next five years does investors a tremendous disservice in evaluating the "true" intrinsic worth of a firm.

Valuation Breakdown

In the chart below, we show the build up to our estimate of total enterprise value for Alphabet and the break down to the firm's total equity value, which we estimate to be about 687.78USD billion. The present value of the enterprise free cash flows generated during each phase of our model and the net balance sheet impact is displayed. We divide total equity value by diluted shares outstanding to arrive at our $995 per share fair value estimate.



In Millions of USD

Source: Alphabet's 16-page equity report, 5/13/2017

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Traditional brokerage analysts may be spending the majority of their time analyzing fundamentals over the next few years, a time frame that accounts for less than one fifth of Alphabet's equity value (see image above). We like to spend the majority of our time looking just past the focus of those 40 analysts, the area in which the most value is created. What this means is that we don't care to differ much from consensus estimates during the next couple years – it's not where we're going to "win the game" or where most of the value composition is generated. As a result, we're laser-focused on striving to get our long-term assumptions "correct" -- a time frame that some market participants may not even be looking at closely!

Within our 16-page stock and dividend reports, our fair value estimates for companies reflect the base-case scenario of our expectations for the company (they do and should not represent an optimistic case or a pessimistic case, but the scenario that we think has the highest probability of occurring). That said, we're well aware that valuation, because it is forward-looking in nature, is not a precise exercise, and the upside and downside cases of our forecasts result in our fair value range for each company (encapsulating the concept of a margin of safety). The intrinsic value of a company will always be a function of the probability of its fair value outcomes.

If you have any questions about how we derive our assumptions within our valuation model, please contact us at info@valuentum.com. If you're using our valuation model template, you may find some helpful commentary in the model Q&A on our discussion board here.

How do we think about the dividend growth rates we assign to stocks?

"No board of directors is going to openly say that its firm's dividend is weak."

In the same light, forecasting dividend growth rates is not an exact science either. For one, the board of directors can choose to raise or lower the dividend at any time it wants, regardless of dividend policy or previous statements. Take the Kinder Morgan (KMI) story of 2015, for example. Management released a press release December 4, 2015, stating that it expected to generate sufficient distributable cash flow (an industry-specific metric we cover in great detail here) to remain on track with its planned 2016 annual dividend hike of 10%. However, less than one week later, December 8, 2015, the company announced a ~75% cut to its originally planned payout for 2016.

Though Kinder Morgan was not in material risk of bankruptcy, maintaining adequate cash flow outside of the payout was necessary for the ongoing healthy functioning of its business, specifically in maintaining a strong credit rating. As you may know, we arguably made one of the best stock calls in recent memory by "removing" the position of Kinder Morgan from the Dividend Growth Newsletter portfolio in June of that year. Others have not been so lucky. In fact, every company that has previously paid a dividend or distribution and has subsequently filed for bankruptcy can look to a board that either was too optimistic about the company's fortunes or did not accurately anticipate the fundamental risks.

As a result, our goal with respect to our dividend forecasts in the dividend reports is to separate ourselves from board decision-making, which could cloud an independent judgment. Instead, we strive to estimate what we think is an achievable growth rate in the firm's dividend per share on the basis of the company's Dividend Cushion ratio and the willingness of management to continue raising it by assessing the consistency and pace of dividend growth in the past. For illustrative purposes, please see the historical trends in McDonald's (MCD) dividend-per-share and our future forecasts in the payout over the next few years. This information can be found in each company's dividend report that we make available.

***Don't Just Look…*continued on next page**

*Don't Just Look…*from previous page

Dividend Track Record				HEALTHY
Fiscal Year	Div's/Share ($)	Div Growth %	EPS ($)	Payout Ratio
Dec-02	0.24	NA	0.77	31.2%
Dec-03	0.40	66.7	1.18	33.9%
Dec-04	0.55	37.5	1.79	30.7%
Dec-05	0.67	21.8	2.04	32.8%
Dec-06	1.00	49.3	2.30	43.5%
Dec-07	1.50	50.0	1.93	77.7%
Dec-08	1.63	8.7	3.76	43.4%
Dec-09	2.05	25.8	4.11	49.9%
Dec-10	2.26	10.2	4.58	49.3%
Dec-11	2.53	11.9	5.27	48.0%
Dec-12	2.87	13.4	5.36	53.5%
Dec-13	3.12	8.7	5.55	56.2%
Dec-14	3.28	5.1	4.82	68.0%
Dec-15	3.44	4.9	4.80	71.7%
Dec-16	3.61	4.9	5.44	66.4%
Dec-17	***3.76***	***4.2***	***6.21***	***60.5%***
Dec-18	*3.89*	*3.5*	*6.69*	*58.2%*
Dec-19	*4.03*	*3.5*	*7.15*	*56.4%*
Dec-20	*4.15*	*3.0*	*7.67*	*54.1%*
Dec-21	*4.27*	*3.0*	*8.22*	*52.0%*

Light green shading denotes a dividend increase, while light red shading denotes a dividend decrease. Heavy green shading denotes a significant dividend increase, while heavy red shading denotes a significant dividend decrease or an excessive payout ratio. NA = Not Applicable.

Ratings as of 17-Mar-2017		Data as of 10-Mar-2017
4	VALUENTUM **Value Rating**	
Div Growth Potential		**Dividend Yield**
POOR		2.94%

Images Source: Valeuntum, McDonald's (MCD) Dividend Report

In some cases, our dividend growth forecasts will not precisely match what a board plans to do with its dividend in the future. We genuinely want to provide readers with an independent opinion of the financial strength of a company's dividend--and what we think is a reasonable annual growth rate to expect on the basis of the company's cash-flow profile, balance sheet health, and dividend track record.

After all, no board of directors is going to openly say that its dividend is weak, and that's why we think an independent assessment holds tremendous value for readers. Our voice is an unbiased opinion based on hard numbers within our discounted cash-flow models. Though there are a variety of exceptions, the future dividend growth rates that we assign to the end of our discrete forecast horizon (2021, in the case of McDonald's above) are generally aligned to the following scale.

Dividend Growth Potential

Excellent: 8% or higher

Good: 4%-8%

Poor: 2%-4%

Very Poor: 0%-2%

Said differently, in most cases, we forecast a company's dividend growth rate in its most recently-reported fiscal year to gradually increase or decrease to this terminal rate over the discrete period. In McDonald's case, for example, the near-term annual dividend growth rate of 4%+ slows to 3%, the mid-point of a rating of 'POOR.' There are instances, however, where we might deviate from the aforementioned scale. Examples of such a scenario can include companies that garner a 'POOR' Dividend Safety rating as a result of past dividend cuts, but have solid dividend growth prospects on the basis of our forward-looking free cash flow-based analysis.

Pharma giant Pfizer (PFE) is an example of this. The company slashed its payout in 2009, but its current free cash flow generating capacity leads us to expect material year-over-year growth in the payout despite its checkered dividend track record, which is the primary cause of its 'POOR' Dividend Safety rating. Though many income-oriented investors may crave an unblemished dividend track record (willingness), we place an equal level of importance on what drives a company's ability to grow the dividend from current levels--balance sheet health and free cash flow generation (capacity).

*Don't Just Look…*continued on next page

Don't Just Look...**from previous page**

Other situations in which we may deviate from the standard dividend-growth forecast scale shown above are for tried-and-true dividend growth entities that may have already had their best dividend growth years. General Mills (GIS) comes to mind as one example. Though we're expecting ongoing dividend growth at General Mills on the back of its steady-eddy business model, a material debt load and recent top-line pressures may cause us to temper our future dividend growth forecasts relative to the scale. Though we have guidelines with respect to our long-term dividend growth forecasts, each company will always be different.

Key Takeaways: Though somewhat quantitative in nature in factoring in long-range projections in our discounted cash-flow valuation models, Valuentum's processes stand on a firm valuation foundation and place greater importance on the long run than on near-term forecasts. Valuentum's expected dividend growth rates for each company are not only cash-flow based but also are independent from board decision making.

If you have any questions about how we derive our forward-looking dividend growth assumptions within our dividend reports, please contact us at info@valuentum.com.

Question: I am wondering about the difference in dividend increases for the current fiscal year between what is showing on your reports and what we believe are the actual increase numbers for some companies. Here are some examples: CL -- Valuentum shows 8.3%; actual increase on 3/6/14 was 5.8%. MDT -- Valuentum shows 7.7%; actual increase on 6/16/14 was 8.9%. CNI -- Valuentum shows 11.0%; actual increase on 1/30/2014 was 16.3% Any thoughts?

The reporting structure of the dividend payments in the dividend reports correspond to when the payments have been paid in previous historical years. So, for example, in CL's case, the company paid the following as dividends in 2013: $0.31, $0.34, $0.34, $0.34 = $1.33 (as shown in the report). The current year 'forecast' (2014) represents the annualized rate based on the current payout ($1.44 per share). The growth rate is then derived as such ($1.44/$1.33-1).

The future forecasts beyond the initial year converge to the following scale (in most cases):

Dividend Growth Potential

Excellent: 8% or higher

Good: 4%-8%

Poor: 2%-4%

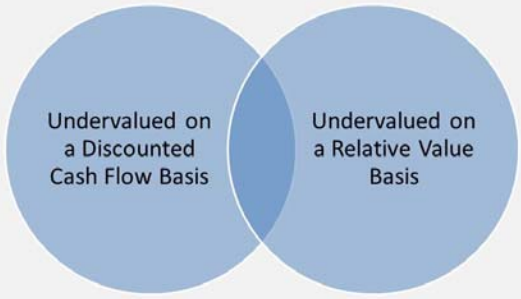
Very Poor: 0%-2%

Note: As is sometimes common when articles are updated or refreshed, previous links within them can become broken. Brian Nelson was previously Director of Training and Methodology Development at Morningstar. Prior to that, he covered aerospace and environmental services companies at the research firm.

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.

[Screen expanded to include stocks with NEUTRAL relative value ratings.]

Company Name	Symbol	DCF Valuation	Relative Valuation	P/FV	Fair Value Estimate
Noble Corp	NE	UNDERVALUED	NEUTRAL	0.44	$9.00
SunPower	SPWR	UNDERVALUED	NEUTRAL	0.46	$15.00
JAKKS Pacific	JAKK	UNDERVALUED	ATTRACTIVE	0.48	$11.00
Ensco	ESV	UNDERVALUED	NEUTRAL	0.51	$12.00
Chicago Bridge & Iron	CBI	UNDERVALUED	NEUTRAL	0.58	$34.00
Syntel	SYNT	UNDERVALUED	NEUTRAL	0.60	$28.00
Gilead Sciences	GILD	UNDERVALUED	NEUTRAL	0.61	$109.00
Synchronoss	SNCR	UNDERVALUED	NEUTRAL	0.62	$26.00
Michael Kors Hldg	KORS	UNDERVALUED	ATTRACTIVE	0.63	$60.00
Seaspan	SSW	UNDERVALUED	NEUTRAL	0.63	$9.00
Continental Resources	CLR	UNDERVALUED	NEUTRAL	0.66	$69.00
Synaptics	SYNA	UNDERVALUED	ATTRACTIVE	0.66	$77.00
R.R. Donnelley	RRD	UNDERVALUED	NEUTRAL	0.67	$19.00
QEP Resources	QEP	UNDERVALUED	NEUTRAL	0.67	$19.00
Rowan Companies	RDC	UNDERVALUED	NEUTRAL	0.67	$18.00
Teva Pharma	TEVA	UNDERVALUED	NEUTRAL	0.68	$52.00
Bed Bath & Beyond	BBBY	UNDERVALUED	NEUTRAL	0.69	$57.00
AMC Networks Inc	AMCX	UNDERVALUED	ATTRACTIVE	0.69	$78.00
Omega Healthcare	OHI	UNDERVALUED	NEUTRAL	0.73	$46.00
Cisco	CSCO	UNDERVALUED	NEUTRAL	0.75	$42.00
Hanesbrands Inc	HBI	UNDERVALUED	ATTRACTIVE	0.76	$27.00
CVS Caremark	CVS	UNDERVALUED	ATTRACTIVE	0.76	$104.00
Sally Beauty	SBH	UNDERVALUED	ATTRACTIVE	0.77	$27.00
Western Union	WU	UNDERVALUED	ATTRACTIVE	0.78	$25.00
Huron Consulting	HURN	UNDERVALUED	NEUTRAL	0.78	$54.00
McKesson	MCK	UNDERVALUED	NEUTRAL	0.79	$188.00
Kroger	KR	UNDERVALUED	ATTRACTIVE	0.79	$31.00

The price-to-fair value measures reflect the metric at the time of report publishing and may differ from today's metric.

*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.

For the first time since the creation of the Valuentum Buying Index, no stocks register a 9 or 10 on the system. The market remains frothy. Please consult the Best Ideas Newsletter portfolio on page 8 for our best ideas.

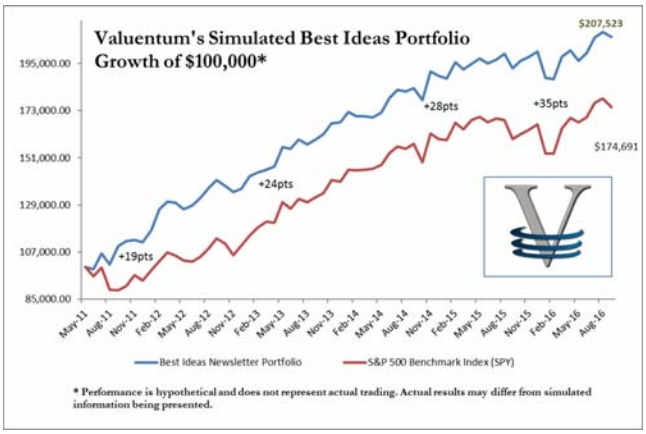
Adobe Systems	ADBE	Information Technology	2
Align Tech	ALGN	Health Care	2
Amazon.com	AMZN	Consumer Discretionary	2
CBOE	CBOE	Financials	2
Clorox	CLX	Consumer Staples	2
Graco	GGG	Industrials	2
InterActive Corp	IAC	Consumer Discretionary	2
Intuitive Surgical	ISRG	Health Care	2
KEMET Corp	KEM	Information Technology	2
Kyocera	KYO	Information Technology	2
Medidata	MDSO	Health Care	2
Mercadolibre	MELI	Information Technology	2
Mettler-Toledo	MTD	Health Care	2
MSCI	MSCI	Information Technology	2
National Beverage	FIZZ	Consumer Staples	2
New Oriental Education	EDU	Consumer Discretionary	2
Northern Trust	NTRS	Financials	2
Raytheon	RTN	Industrials	2
Roper Technologies	ROP	Industrials	2
Royal Caribbean	RCL	Consumer Discretionary	2
SBA Comm	SBAC	Telecom Services	2
Sherwin-Williams	SHW	Consumer Discretionary	2
Tesla	TSLA	Consumer Discretionary	2
Ulta Salon	ULTA	Consumer Discretionary	2
Waters	WAT	Health Care	2

Autodesk	ADSK	Information Technology	1
Badger Meter	BMI	Industrials	1
Brown-Forman	BF.B	Consumer Staples	1
CACI Intl	CACI	Information Technology	1
CONSOL Energy	CNX	Energy	1
Diageo	DEO	Consumer Staples	1
Donaldson Co	DCI	Industrials	1
Equinix	EQIX	Telecom Services	1
Heartland	HTLD	Industrials	1
Hyatt	H	Consumer Discretionary	1
Intercontinental	IHG	Consumer Discretionary	1
Jack Henry	JKHY	Information Technology	1
Jack in the Box	JACK	Consumer Discretionary	1
Kraft Heinz	KHC	Consumer Staples	1
Manhattan Associates Inc	MANH	Information Technology	1
MGE Energy	MGEE	Energy	1
Middleby	MIDD	Industrials	1
NuVasive	NUVA	Health Care	1
RBC Bearings	ROLL	Industrials	1
Scotts Miracle-Gro	SMG	Materials	1
STMicroelectronics	STM	Information Technology	1
Synopsys	SNPS	Information Technology	1
Teleflex	TFX	Health Care	1
T-Mobile	TMUS	Telecom Services	1

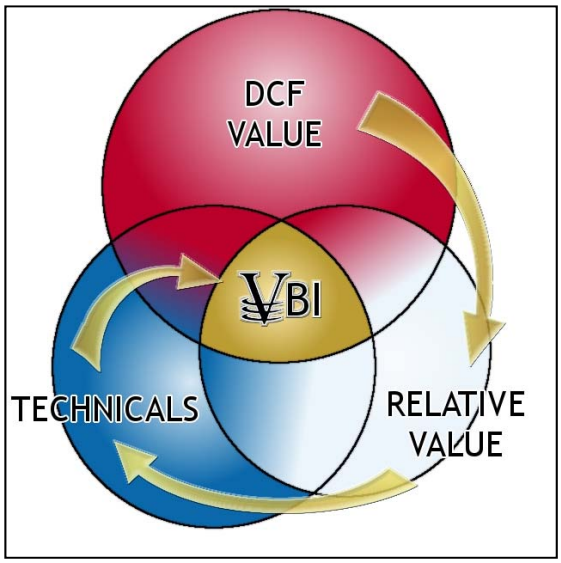
Our Methodology – The Valuentum Buying Index (VBI)

By Valuentum Analysts

At Valuentum, we think some of the best opportunities arise from an understanding of a variety of 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, we posit 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.



We think 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 generally 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 discounted cash flow (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 target the long term, and we want to have a strong process to support the ideas we deliver to our subscribers.



Our Methodology – The Valuentum Buying Index continued on next page

Our Methodology – The Valuentum Buying Index continued from previous page

The center of the Venn diagram above, the Valuentum Buying Index (VBI) combines rigorous financial and valuation analysis with an evaluation of a firm's technicals and momentum indicators to derive a rating between 1 and 10 for each company (10=best). Because the process factors in a technical and momentum assessment after evaluating a firm's investment merits via a rigorous DCF and relative-value process, the VBI attempts to identify entry and exit points on what we consider to be the most undervalued stocks.

We think research firms that just focus on valuation may expose readers to a stock on its way down (a falling knife), while those that just use technical and momentum indicators may expose portfolios to significantly overpriced stocks at their peaks. It is our view that only when both sides of the investment spectrum are combined can investors find undervalued stocks at potentially timely prices for consideration.

Let's examine the chart below, which showcases how the Valuentum process, by definition, may have the greatest profit potential of any common 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). We define the Valuentum strategy as capturing the entire equity pricing cycle, while the value and momentum strategies individually truncate profits, as illustrated in the image below.

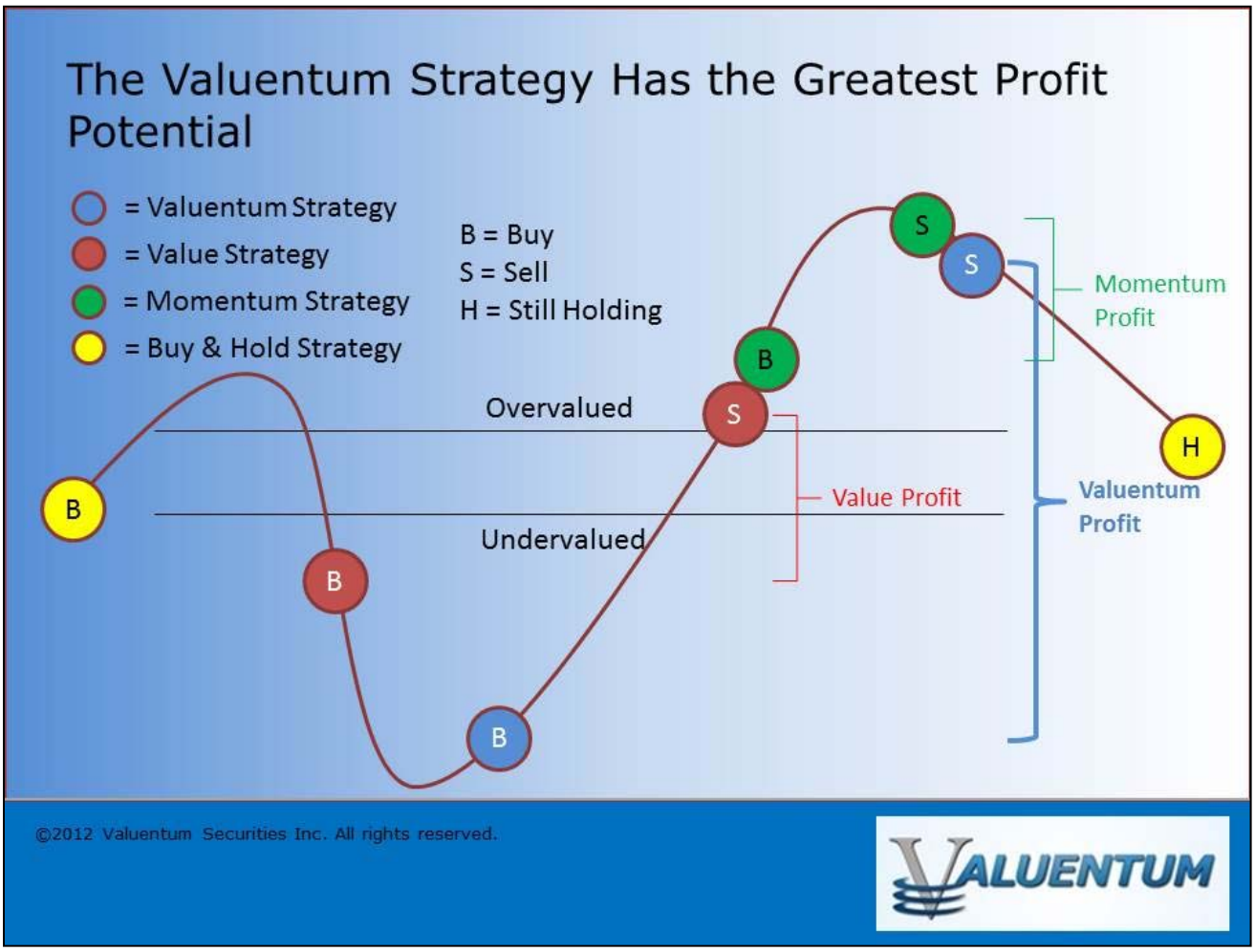


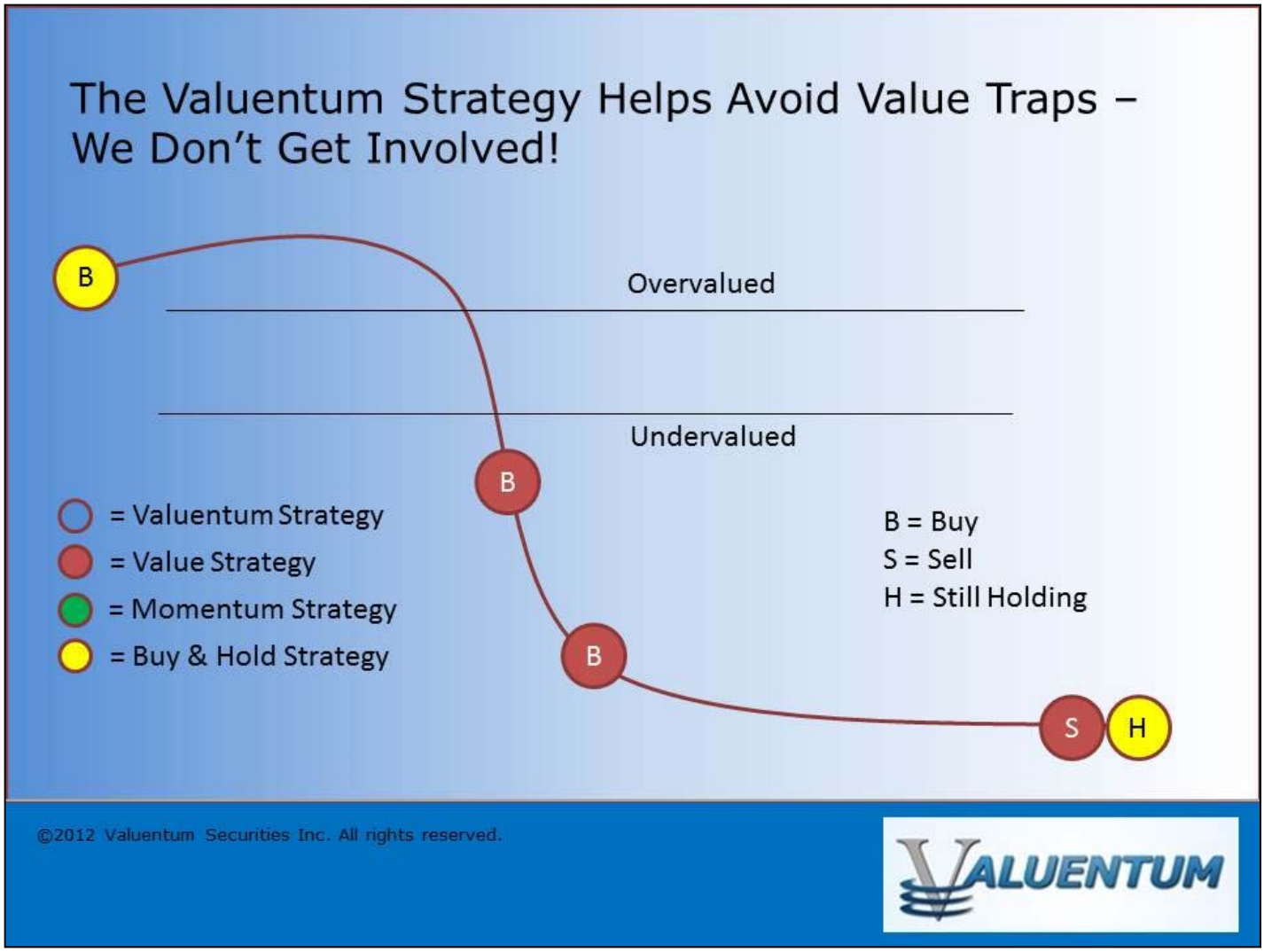
Illustration for educational purposes only.

Our Methodology – The Valuentum Buying Index continued on next page

Our Methodology – The Valuentum Buying Index continued from previous page

Furthermore, we think Valuentum subscribers are less likely to be involved in so-called value traps because we demand material revenue and earnings growth for firms to earn a 10 on the 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 often a falling stock price). We also think Valuentum subscribers are less likely to be exposed to these "falling knives" since the process requires firms to not only be undervalued, in our opinion, but also be exhibiting bullish technical and momentum indicators before we would consider adding them to the newsletter 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 attempts to steer clear of these situations. The Valuentum Buying Index is designed to wait for technical improvement in the equity, which often precedes fundamental changes at the company.



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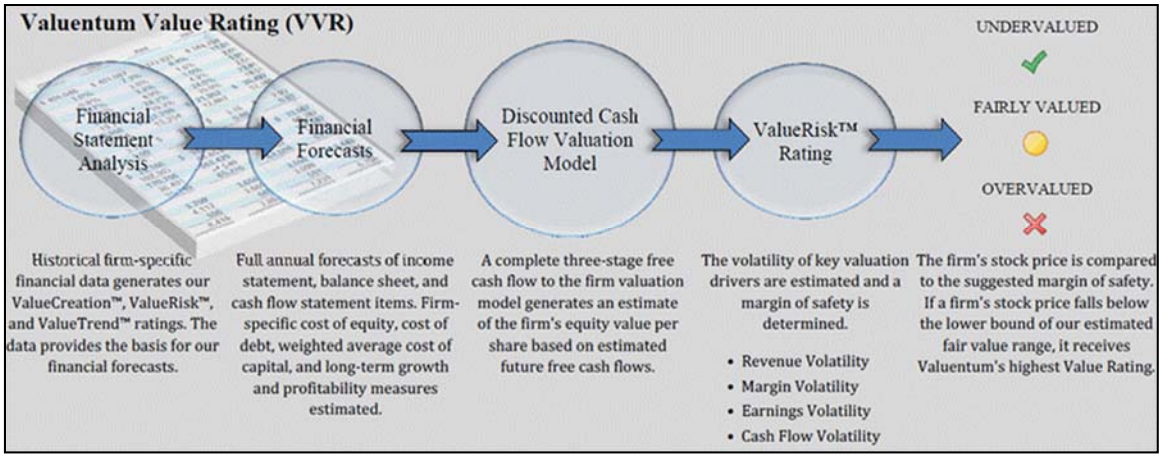
Our Methodology – The Valuentum Buying Index continued on next page

Our Methodology – The Valuentum Buying Index continued from previous page

Let's walk through the three investment pillars of our stock-selection methodology.

I. The Valuentum Buying Index Applies A Rigorous Discounted Cash Flow Valuation Process

The Valuentum Buying Index 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.



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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 may provide investors with opportunities to buy attractive stocks at bargain-basement levels, in our view. A forward-looking Economic Castle rating is then derived.

We then assess each company within our 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 (DCF) valuation helps to prevent investors from exposing their portfolios to significantly overpriced stocks at their peaks. The image below reveals how pure momentum investors may expose their portfolios to pricing extremes and dramatic falls (green circles: Buy --> Sell). The Valuentum Buying Index attempts to steer clear from these situations.

Our Methodology – The Valuentum Buying Index continued on next page

Our Methodology – The Valuentum Buying Index continued from previous page

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II. The Valuentum Buying Index Incorporates 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. The Valuentum Buying Index Seeks 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 in an attempt to consider entry and exit points on the stock (but only after it meets our stringent

Our Methodology – The Valuentum Buying Index continued on next page

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valuation criteria).

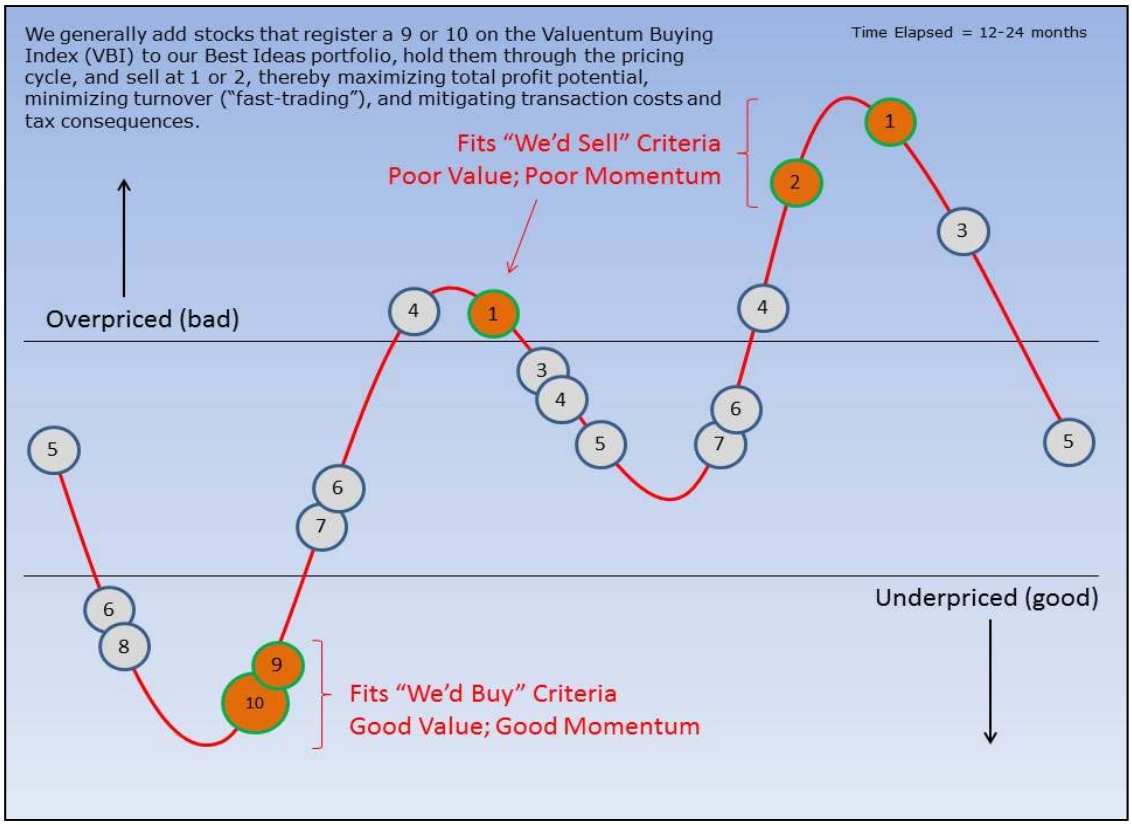
Rigorous valuation analysis and technical analysis are not mutually exclusive, and we believe both can be used together to bolster idea generation. An evaluation of a stock's moving averages, relative strength, upside-downside volume, and money flow index are but a few considerations we look at with respect to a 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 in an attempt to help safeguard against value traps, falling knives, and the opportunity cost of holding an undervalued equity for years before it potentially converges to "fair value." Other research firms may 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, on a theoretically basis, we would expect our best ideas to "work out" over a 12-24 month time horizon (on average) -- the duration of any individual idea can vary considerably, however. We tend to include firms in the Best Ideas Newsletter portfolio when they register a 9 or 10 on our Valuentum Buying Index (VBI) and tend to remove firms from the Best Ideas Newsletter portfolio when they register a 1 or 2 on the Valuentum Buying Index.

In theory, the Valuentum Buying Index attempts to maximize profits on every idea within the Best Ideas Newsletter portfolio, 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), for example, may truncate potential profits, while a momentum strategy (4 --> 1), for example, may ignore profits generated via value assessments. The Valuentum Buying Index seeks to capture the entire profit potential, as shown below.



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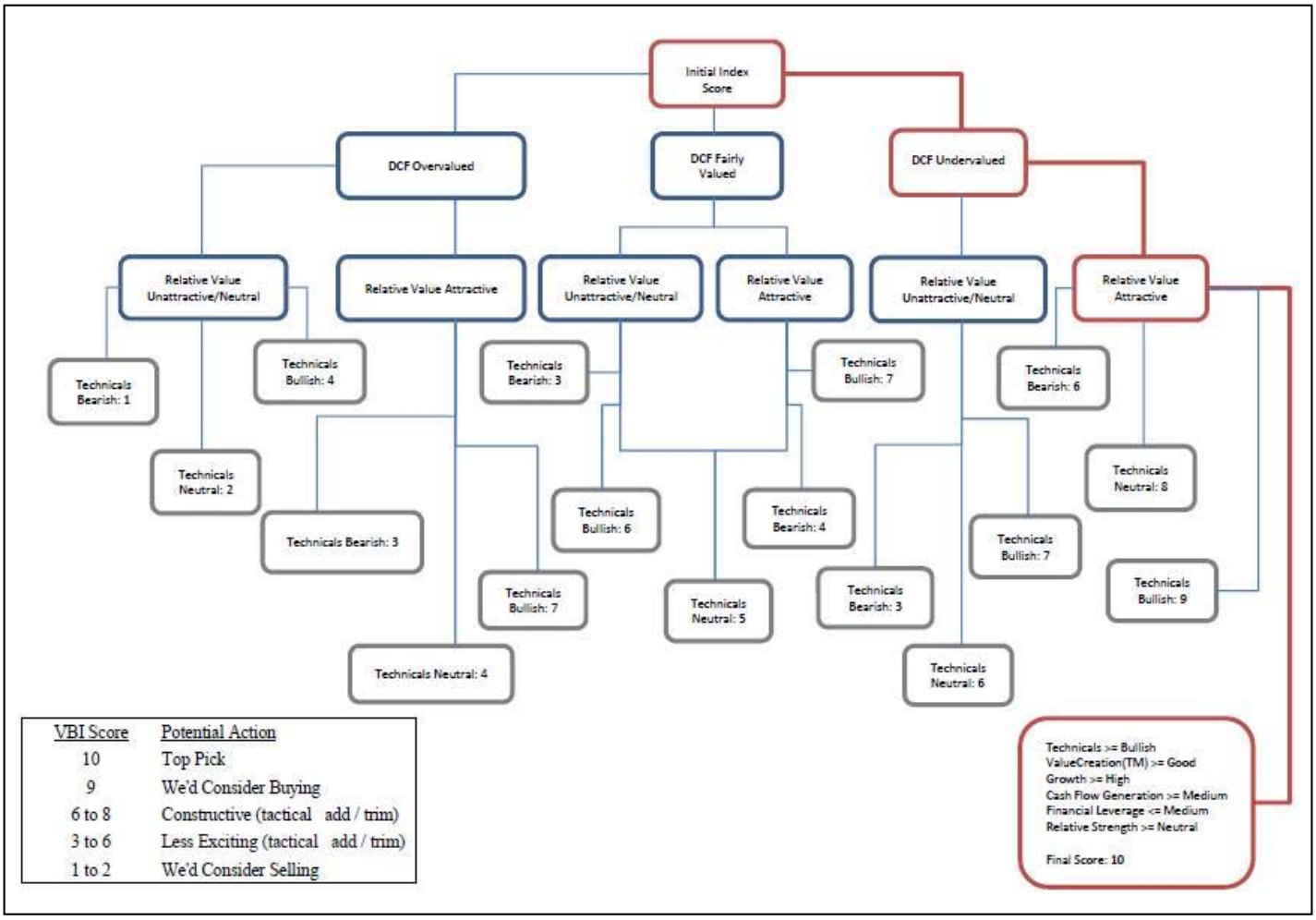
Our Methodology – The Valuentum Buying Index continued on next page

Our Methodology – The Valuentum Buying Index continued from previous page

Let's follow the red line on the flow chart below to see how a firm can score a 10, the best mark on the Valuentum Buying 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. Firms that don't make the cut for a 10 are ranked accordingly, with the least attractive stocks garnering a score of 1 ("We'd sell"). Most of our coverage universe falls between 3 and 7, but at any given time there could be large number of companies garnering either high or low scores, especially at market lows or tops, respectively.



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

Illustration for educational purposes only.

Our Methodology – The Valuentum Buying Index continued on next page

About the Fair Value Range

By Valuentum Analysts

Understanding the Fair Value Range and Why It's Important

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

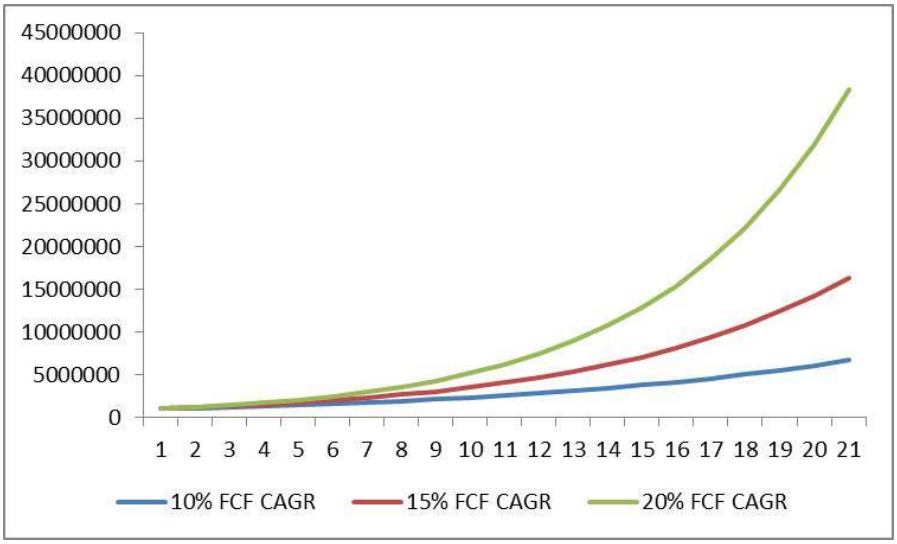
One of the most important concepts of the Valuentum methodology (and valuation in general) is the understanding that the value of a company is a range of probable valuation outcomes, not a single point estimate. Even well-seasoned stock analysts are guilty of saying that a company's shares are worth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

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

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

But why the large range in many cases?

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



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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.

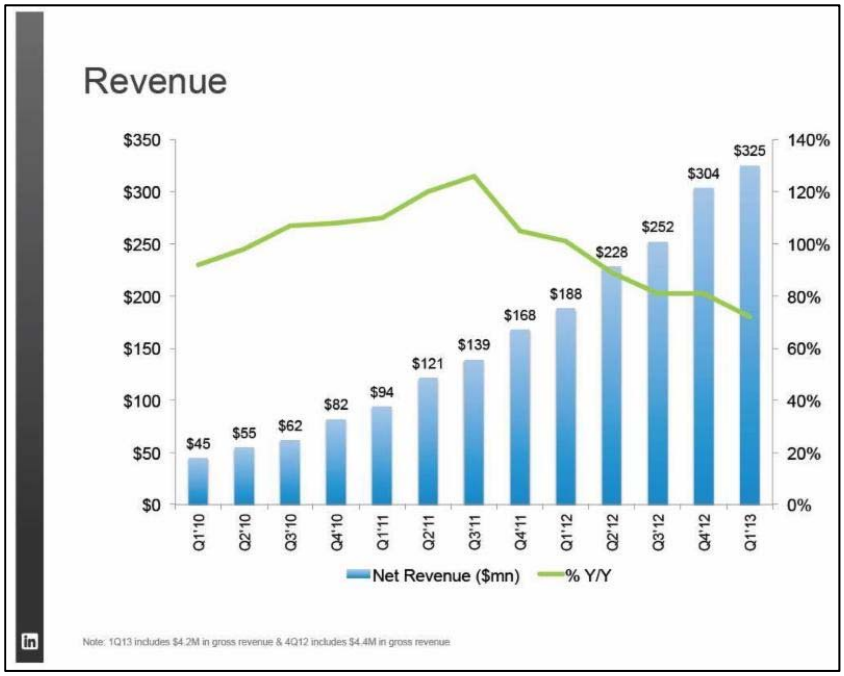

Image Source: LinkedIn

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 1,000+ 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.*

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

By Valuentum Analysts

We often receive questions about how we use the Valuentum Buying Index (VBI) rating system, one of the key metrics we use to source ideas, but we think it is equally important to mention up front 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! Don't forget about the Economic Castle rating and the Nelson Exclusive publication, too.

No matter your strategy or process though (it is not for us to say what is best for you), 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 evaluate as 1, 2, 3, or even buying 9s and 10s and selling 1s and 2s until their VBI changes upon the next update. Generally speaking, we measure the process over longer-term time periods--from the time a company registers a rating to a defined time in the future--not an interim update basis. Please read more about the parameters of a case study here, where Valuentum Buying Index ratings, as of September 2013, were recorded and the performance of stocks were measured from that time through September 2014.

The Valuentum Buying Index Has Checks and Balances

With prudence and care, the Valuentum Buying Index process and its components are carried out. Our analyst team spends most of its time thinking about the intrinsic value of companies within the context of a discounted cash-flow model and evaluating the risk profile of a company's revenue model. We have checks and balances, too. First, we use a fair value range in our valuation approach as we embrace the very important concept that value is a range and not a point estimate. A relative value overlay as the second pillar helps to add conviction in the discounted cash-flow process, while a technical and momentum overlay seeks to provide confirmation in all of the valuation work. There's a lot happening behind the scenes even before a VBI rating is published, but it will always be just one factor to consider.

Within any process, of course, we value the human, qualitative overlay, which captures a wealth of experience and common sense. We strive to surface our best ideas for members, and flying blind is never a good strategy, in my opinion. 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. That's why the VBI has checks and balances and focuses on the discounted cash-flow process first and foremost, but the human, qualitative overlay is still extremely important, especially when considering various business models and unique "un-modelable" risks. In our 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, for the sake of transparency, we measure the performance* of the portfolios in the Best Ideas Newsletter and Dividend Growth Newsletter. The portfolios, in part, 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 screens -- listings of companies with similar data and information (see left column of the website). The ideas in the portfolios in the Best Ideas Newsletter and Dividend Growth Newsletter have been evaluated by our analyst team for consideration in the newsletter portfolios. 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 this is important. In a market environment where more than 90% of large-cap funds have trailed the S&P 500 in the 5-year period ending August 31, 2016, the Best Ideas Newsletter portfolio* has exceeded its benchmark return over a similar time period. What's more, we showcased this performance in full transparency, and we wrote every single day, and some days weren't all that great. When patience

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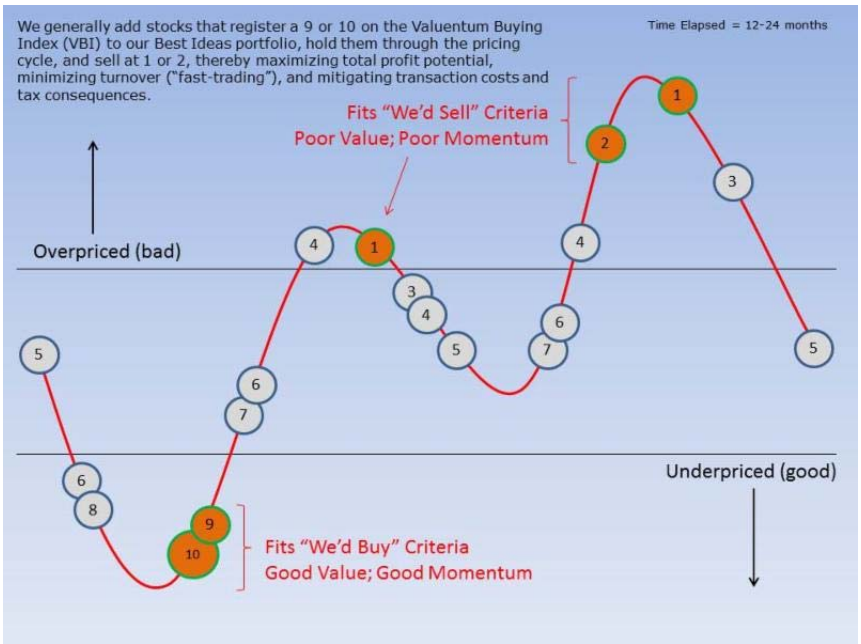
is the secret to success in investing, a lot could have gone wrong with the temptation to do something each day. Obviously, we're very disciplined, but we also credit the portfolio outperformance to the VBI methodology itself. It is a very helpful tool.

** Actual results may differ from simulated information being presented. The Best Ideas Newsletter portfolio and Dividend Growth Newsletter portfolio are not real money portfolios. Results are hypothetical and do not represent actual trading.*

The Valuentum Buying Index Is One of Many Important Factors to Consider

That said, let's talk about how the VBI helps to inform which ideas we include in the Best Ideas Newsletter portfolio. This is where some clarification is probably important. For one, the word choice is critical, "inform," because the VBI is generally just one factor that goes into whether we add a company to the Best Ideas Newsletter portfolio, even if the VBI is one of the most important factors. Second, the timing element or duration concept is a key consideration. We've noticed via our statistical backtesting that a momentum factor can 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 consider this dynamic with the update cycle of our reports (and the time horizon for 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 think portfolio churn is the way to generate outperformance. Momentum may be high turnover, but Valuentum is low turnover.

Though the time frame varies depending on each idea that we consider for the Best Ideas Newsletter portfolio, we would expect our best ideas to generally work out over a 12-24 month time horizon (on average). Not all ideas will be successful, however. Our "holding period" is targeted to be much, much longer for some ideas in the Dividend Growth Newsletter portfolio, as income and dividend growth are other key factors (in addition to the Valuentum Buying Index and capital appreciation potential). The time horizon or duration concept is where the Valuentum Buying Index rating system becomes more complicated than a simple 1, 2, 3. For example, 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, based on dividend-related considerations).



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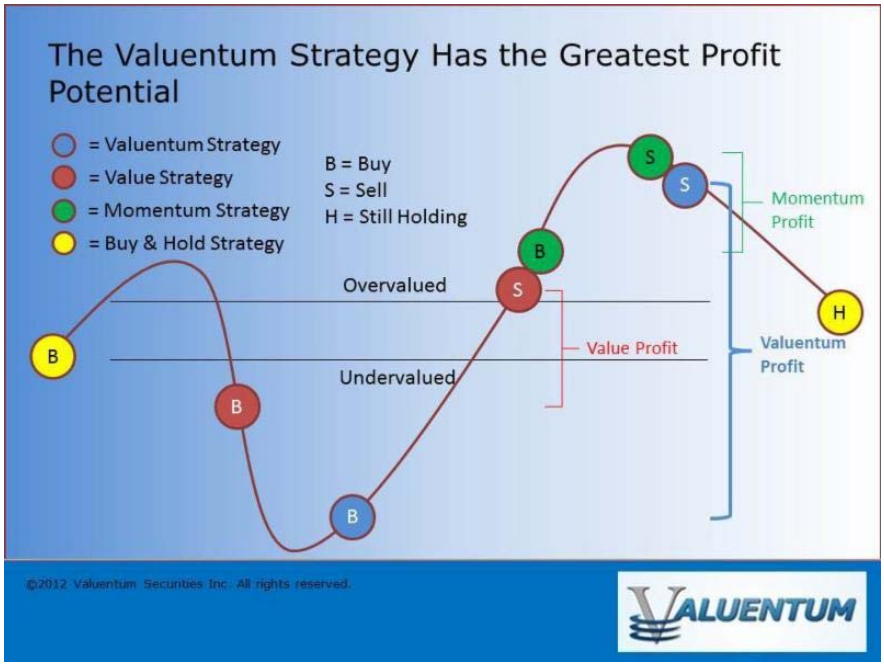
But why don't we churn our ideas by updating daily and trading a lot? Obviously, we don't think that's the secret to investment success. In quite the opposite approach, we strive to maximize profits on every idea that we pursue, with the understanding that momentum does exist and that prices over and 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 "outperformance" of the Best Ideas Newsletter 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).



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Not All Highly-Rated Stocks Are Added to the Newsletter Portfolios

Regarding the Valuentum process, as it is executed in the Best Ideas Newsletter portfolio, we do not "add" all stocks 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. Macro-economic, broader market valuation, and sector weighting considerations are other factors that impact the qualitative portfolio management process.

But why not add every highly-rated stock on the Valuentum Buying Index 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, in his or her opinion -- 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 we use the VBI in the Best Ideas Newsletter portfolio, however, is a qualitative portfolio management overlay. The VBI rating helps to inform the

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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 even have to relax the VBI criteria entirely in order to do what we think is required to achieve newsletter portfolio goals.

Some Examples of the Valuentum Buying Index In Action

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 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 (as in the eBay example). Not to be overlooked either, the Valuentum Buying Index rating also informs us when we may consider "removing" a position from the newsletter portfolios. Kinder Morgan (KMI), for example, registered a 1 on the Valuentum Buying Index just prior to its notorious fall and dividend cut. 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.

In all, the Valuentum Buying Index 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. Of course, please always contact your financial advisor to determine if any idea or strategy may be right for you.

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About Our Name

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

-- Warren Buffett, Berkshire Hathaway annual report, 1993

At Valuentum, we take Buffett's thoughts one step further. We think the best opportunities arise from a complete understanding of all investing disciplines in order to identify the most attractive stocks at any given time. Valuentum therefore analyzes each stock across a wide spectrum of philosophies, from deep value to momentum investing. And a combination of the two approaches found on each side of the spectrum (value/momentum) in a name couldn't be more representative of what our analysts do here; hence, we're called Valuentum.

Valuentum Best Ideas Newsletter: Volume 7, Issue 7

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