OUR BEST IDEAS NEWSLETTER

Valuentum Securities

Stock Analysis: From Value through Momentum Investing

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

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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.

Inside This Issue

"When it comes to investing, as in war, the long-term strategic objective will always trump any short-term win, so please don't lose sight of the portfolio context, especially when it comes to the concept of diversification."

- 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.

Strategy Versus Tactics in the Best Ideas Newsletter Portfolio

By Brian Nelson, CFA

New for 2018! See page 9.

I'm *not* going to reference *The Art of War* written by Chinese military strategist Sun Tzu some time in the 5th century, nor am I going to use any quotes from the military treatise (I think it's too well-traveled of a topic), but I do believe the approach to portfolio management is much like that of a general on a path to win the war. Now, don't get me confused: I'm not saying that portfolio management is actually like being in war. Not. A. Chance. I'm saying that the planning, the thinking, the goal in forming an overall strategy and executing tactical tweaks to win is similar. Obviously, nothing comes close to the brave men and women on the field of battle and what they sacrifice, but I like the comparison, so I am going with it.

Though not always completely accurate, one way of thinking about the difference between strategy and tactics is that, in most cases, strategy can be considered long term, while tactics can be considered short term. Strategy = long-term goals. Tactics = short-term tweaks. If you recall in one of the greatest movies perhaps of all time, *Saving Private Ryan*, Captain John Miller, played by Tom Hanks, hits one of the most powerful tones in the movie when he says: "Our objective is to win the war." On a search and rescue mission for Corporal Francis Ryan, Miller and his squad encountered an enemy machine gun emplacement. Instead of going around it, Miller understands what must be done. The overall, long term strategic goals of the United States of America are to win the war, and the emplacement must be neutralized. Miller understood.

The difference between strategy and tactics can also be readily explained through other examples in history. One of the most notorious instances of overemphasizing short-term tactics versus long-term objectives occurred after the Battle of Gettysburg in 1863. Union Army General George Meade, who field-marshalled the victory for the Blue during that three-day battle in July, telegraphed Lincoln shortly after: driven "from our soil every vestige of the presence of the invader." Lincoln was furious by the message: "Drive the invaders from our soil! My God! Is that all? … You will follow up and attack General [Robert E.] Lee as soon as possible before he can cross the river. If you fail, this dispatch will clear you from all responsibility and if you succeed you

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may destroy it." Meade had only been focused on the tactical victory at Gettysburg, not the strategic goals of the United States of America to eradicate the Confederacy. Meade lost his job.

Focusing on tactical victories has always been a very short-sighted view when it comes to striving to achieve overall long-term strategic objectives, not only in war but also in portfolio management. Frank Reilly and Keith Brown wrote in their book, *Investment Analysis and Portfolio Management*, that "...about 90% of the maximum benefit of diversification was derived from portfolios of 12 to 18 stocks." In the context of portfolio management, and generally speaking, in our view, a portfolio of ~20 companies may be sufficient to achieve meaningful diversification, provided that such stocks are also diversified across sectors. This is partly why the Best Ideas Newsletter portfolio and Dividend Growth Newsletter portfolio generally emphasize ~20 ideas, and why we don't cram or force more ideas within the newsletter portfolios. We're not getting much more diversification benefit beyond those 20 or so widely-diversified stocks, so we don't need more. If we add more, we'd just be adding the next best idea, when we could be adding to a better idea already in the portfolio.

We may make tactical tweaks, but the overall strategy is set with the ideas already in the newsletter portfolios. The strategy matters. The tactical tweaks are important, but of lesser importance. But keep all of this in perspective, too. An equity portfolio, of course, is only one part of a well-diversified financial plan, which may also include cash for emergency needs, an owned property (a house or rental for income), and bonds, among other assets. The newsletter portfolios such as the Best Ideas Newsletter portfolio and Dividend Growth Newsletter portfolio, and the ideas within them may be but a small part of the big financial picture, and the tactical tweaks within the newsletter portfolios may only be a much smaller part of that same picture. In some ways, the tactical tweaks made in the newsletter portfolios shouldn't bear much weight on one's overall financial picture at all. If they do, a person may not be thinking about their overall strategy; instead a person may be focusing more on short-term tactical endeavors, which are only a small part of winning the war.

The Best Ideas Newsletter Portfolio

2017 Tactical Evaluation of Best Ideas Newsletter		1	2	3	4	5	6
Date	Tactical Decision	Very Poor	Poor	Neutral	Good	Excellent	Phenomenal
January 6 2017	Add CVS Health (CVS)		x				
April 13 2017	Add Dollar General (DG)					x	
April 13 2017	Add Verint Systems (VRNT)				x		
April 13 2017	Remove Republic Services (RSG)			x			
May 15 2017	Remove General Electric (GE)						x
May 17 2017	Put Option Hedges (S&P, Netflix)			x			
May 25 2017	Remove Kinder Morgan (KMI)				x		
May 25 2017	Remove Bank ETFs (XLF, KBE)		x				
May 25 2017	Remove Teva Pharma (TEVA)						x
May 25 2017	Remove Michael Kors (KORS)	x					
June 20 2017	Remove Buffalo Wild Wings (BWLD)		x				
July 19 2017	Add to Facebook (FB)					x	
July 31 2017	Add Gilead (GILD)		x				
July 31 2017	Remove Half of Altria (MO)			x			
August 18 2017	Remove Union Pacific (UNP)		x				
August 18 2017	Remove Half of Apple (AAPL)		x				
August 18 2017	Remove Half of Priceline (PCLN)				x		
2017	**Number**	**1**	**6**	**3**	**3**	**2**	**2**
Weighted Average	**3.29 -- Neutral/Good**						

Source: Best Ideas Newsletter portfolio transaction log

We covered how well the ideas that were in the Best Ideas Newsletter portfolio and Dividend Growth Newsletter portfolio performed during 2017 in a *big-picture, strategic sense* (see here and here, respectively), but how have some of the tactical tweaks as it relates to the newsletter notifications

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in 2017 on the margin performed? We're splitting hairs because we are taking these ideas out of the portfolio context (a big no-no), but let's see how some of the tactical moves of 2017 panned out. Let's cover the first idea of 2017, CVS Health (CVS). The company was added to the Best Ideas Newsletter portfolio in January 2017, and shares are off more than 10% at the time of this writing, to ~$70. Frankly, we were blindsided by Amazon (AMZN)'s purchase of Whole Foods (WFM) this year, and we're not happy with the implications--but that's why diversification is so important.

In the Best Ideas Newsletter portfolio, we added a 1.5% position in Dollar General (DG) and a 1.5% position in Verint Systems (VRNT) on April 13, 2017. Dollar General was added at $68.83, while Verint Systems was added at $38.95. Shares of Dollar General have surged nearly 30%, to ~$87, while Verint Systems has advanced to ~$43, a 10%+ move, both prices at the time of this writing. Interestingly, adding Dollar General and Verint, while at the same time removing Republic Services (RSG), the price of which has effectively remained unchanged, was a very good move. An even better move, in May, we cut General Electric from the newsletter portfolios, and while this doesn't show up in the performance column, it was a huge win, as it saved the portfolios from the considerable loss that followed.

While CVS was a tactical misstep, the decisions with respect to Dollar General, Verint, Republic Services and General Electric were tactical wins. Unfortunately, however, the put option ideas that then followed in Netflix (NFLX) and the S&P 500 Sector ETF (SPY) set us back, but sometimes losing a battle can be okay, especially when it means protecting the entire army. For example, unlike with respect to CVS Health, Dollar General, Verint Systems, Republic Services, and General Electric, it's okay that the put option ideas didn't work out. The newsletter portfolios still advanced, despite this protection not paying off; it may be speaking the obvious, but we want the newsletter portfolios to do well, and it's difficult to ding us for being prudent and conservative.

In late May, we did some spring cleaning, removing Kinder Morgan (KMI), the Financial Select Sector SPDR (XLF), the SPDR S&P Bank ETF (KBE), Teva Pharma (TEVA) and Michael Kors (KORS). Kinder Morgan has continued its aggressive fall after we removed it, another tactical win, while removing the two bank ETFs may have been tactical shortcomings, but both positions had been big winners since being originally added to the Best Ideas Newsletter portfolio. Incredibly, we removed Teva at $28.67 and shares are now exchanging hands at $14.26 at the time of this writing, a huge tactical win. On the other hand, top-VBI-rated Michael Kors' shares have advanced considerably, a tactical blunder, especially since the company was so highly-rated on the Valuentum Buying Index. Our methodology is working (see here), and we need to stick with it! The same can probably be said for Buffalo Wild Wings (BWLD), the equity price of which having advanced after being removed from the newsletter portfolio in June 2017.

July 2017 was a great month in that we tactically decided to add another three percentage points of exposure in the Best Ideas Newsletter portfolio to the position in Facebook (FB) in the mid-$160s; shares are now trading over $180 at the time of this writing. We also added Gilead (GILD) in late July at $76.32, and shares are off just a bit trading at ~$72 each at the time of this writing. The decision to remove half of the position in Altria (MO) proved to effectively be a wash, given that the company's equity is essentially at the same level since the end of July. The August ideas to remove Union Pacific (UNP), half of Apple (AAPL) and half of Priceline (PCLN) were mixed, with the first two coming up tactically short, but the last one a tactical win.

Those are they. When you see all the tactical changes in the Best Ideas Newsletter in aggregate for 2017, it's clear that we've been very busy this year, arguably too busy. Many of the tactical moves could be considered poor in light of the performance subsequent to the decision, but several were excellent/phenomenal. For the most part, however, we think a neutral/good ranking may capture the essence of the tactical moves in the Best Ideas Newsletter portfolio this year. Though we'll stop measuring the performance of the Best Ideas Newsletter portfolio and Dividend Growth Newsletter portfolio effective at the end of 2017 in lieu of a list-and-weighting format, we're certainly not disappointed by any stretch of the imagination. We hope you're not either.

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Remember: When it comes to investing, as in war, the long-term strategic objective will always trump any short-term win, so please don't lose sight of the portfolio context, especially when it comes to the concept of diversification. A position that is approaching 8%-10% of the total portfolio is a highly concentrated one, in my view, and very few of our ideas have ever reached those levels in the most recent past. In previous work, we showed how the weightings of ideas within the portfolio are of critical importance to executing on a long-term strategy (and can be more important than the ideas themselves), and in this piece, how the moves we make during each year are short-term tactical tweaks that we hope will augment the overall long-term strategy of each respective newsletter portfolio given current market conditions. Though we evaluated them as such, short-term tweaks should not be viewed in isolation, just like a battle can never ever be more important than the war itself.

Nelson on Bogle, Part I

"The kind of commentary that makes broad generalizations about expectations of future returns is exactly why people are so eager to get into passive investment strategies. Since the 1920s, it seems as though the individual investor has assumed the stock market was rigged or impossible for average Joes to figure out, but instead of the "I'll get it next time" mentality that was present leading to the crash of '29, individual investors have "evolved" to the point that now the idea is if you can't beat the market, just buy the whole thing. Leaders like Bogle continue to take tremendous shortcuts in explaining forecasts, leaving the average investor like a student trying to copy math homework off a peer that didn't show his/her work. When the test comes around, and the problem is a bit different, the copier is up a creek." -- The Valuentum Team

By Brian Nelson, CFA

Image shown: An example illustrating how the dividend is a component of capital appreciation that otherwise would have been achieved had the dividend not been paid. Such a situation applies to both regular and special dividends.

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

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Passive investing, or investing in a broad basket of stocks at any price and holding regardless of what happens, has become an increasingly popular investment hobby in recent years. Surely, a shopper of groceries would wait for items to go on sale at the store to make a purchase, but when it comes to investing, the price that investors are willing to pay for stocks seemingly doesn't matter for indexers. How has this happened? Are they being deceived?

Part of the breakdown in the logic, we posit, comes from making broad generalizations about expectations of long-term returns. The indexer seems to have completely forgotten about how present conditions can impact future returns, the very likelihood that future returns can even be negative, if investments are held at or near market tops, and that future positive returns for a market can never be guaranteed. It may not matter if market tops can be identified with precision either. The very idea that there are examples where market returns have been negative for years and even decades is enough proof that making broad generalizations about the expectations of future returns is about as ridiculous as it gets.

What's more, how John C. Bogle, the founder and retired CEO of the Vanguard Group, makes his forecast of future returns, as we reproduce below, only seems to confuse investors even more, in our view, to the point where they then may believe that the dividend payment is somehow incremental to a capital appreciation component. This is not true. The payment of the dividend theoretically detracts from the capital appreciation a stock would otherwise have achieved. Separating dividends as Bogle does in his variables that determine stock market returns, as shown below, implies that paying a dividend is an addition to stock market returns. That's backward thinking.

Though history has shown dividend payers have the propensity to outperform non-dividend payers over time, we think it is critically important that readers understand that the dividend, itself, is not incremental to returns, but instead it is a form of capital appreciation that is instead paid out to shareholders. The most prominent instance of this can be observed when a company pays a large special dividend, for example--e.g. Cracker Barrel (CBRL) here. In such an example, as in any other example of when a dividend is paid, a stock's share price is adjusted down, at market open, by the amount of the dividend payment, special or regular. The dividend is not incremental--it detracts from the capital appreciation that otherwise would have been achieved. See image at the top of this article.

How many investors don't understand this about the dividend! Is Bogle's forecasting technique, widely followed by investors, only making matters worse?

From *Common Sense on Mutual Funds*, written by John C. Bogle:

These variables determine stock market returns over the long term:

> *1) The dividend yield at the time of initial investment.*
>
> *2) The subsequent rate of growth in earnings.*
>
> *3) The change in the price-earnings ratio during the period of investment.*

The total of these three components explains nearly all of the stock market's returns over extended holding periods. By analyzing the contribution to total return of the three factors, reasoned consideration of future returns can take place. The initial dividend yield is a known quantity. The rate of earnings growth has usually been relatively predictable within fairly narrow parameters. And the change in the price-earnings ratio has proven highly speculative. Total return is simply the sum of these three factors. For example, an initial dividend yield of, say, 3 percent plus a forecasted earnings

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growth of 7 percent annually over the next 10 years would bring the return to 10 percent. A change in the price-earnings ratio—from, say, 15 times at the beginning of the period to a forecasted 18 times at the end—would add 3 [sic] percentage points to that total, bringing the return on stocks to 13 [sic] percent. – John C. Bogle, Common Sense on Mutual Funds

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John C. Bogle is one of the most influential people in the investment world. For those that don't know Bogle, he is credited with popularizing index funds and driving costs significantly lower across the mutual fund industry. There are even large groups of investors dedicated to following investing advice inspired by Bogle – they are called Bogleheads. The excerpt above from his highly-influential book *Common Sense on Mutual Funds*, pages 37-38 in my copy, may be helpful to the beginning investor looking to get some idea of what drives the long-term returns of stock prices, but what I would like to do is expand upon these three drivers so members know exactly how these three components interact with each other.

Understanding Total Return

As Bogle indicated, merely as a starting point, the total return of any stock can be broken into three pieces: dividend income (1, dividend yield) and capital appreciation (2, rate of growth in earnings and 3, change in price-earnings ratio). The best way to explain total return, in my view, however, may be to walk through a hypothetical individual's personal financial situation as an example. That way we'll take corporate speak out of it, especially if the example with Cracker Barrel above didn't quite sink in with respect to the dividend.

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

Interestingly, we can value this hypothetical person's financial situation the same way that we can value a stock. Let's first assess the person's future income stream in present value terms. Though this person will not work forever, for simplicity, let's use a standard growing perpetuity function to value his/her income stream. Here's what the equation looks like:

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

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

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

(cash less debt)

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

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

Understanding How Dividends Interact with Capital Appreciation

What would the present value of this person's financial statement be one year hence? Let's keep it simple and ignore living expenses and assume that out of the $25,000 in after-tax earnings generated during the year, $5,000 went toward paying down debt and $20,000 went directly to savings. For simplification purposes, let's ignore interest received on cash and interest paid on debt, too. The standard perpetuity of the person's income stream would be valued the same one year into the future,

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or $515,000. However, the personal balance statement would be different one year hence. Here's the new equation:

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

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

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

Let's now see what happens in a case where this person pays himself/herself a personal dividend, perhaps a trip to the south of France that costs $10,000. This concept may be confusing in this example, but think of capital flowing out of one's pocketbook as similar to a company paying a special dividend, for example. Instead of the $20,000 going into the savings, as in the previous scenario, only $10,000 would go into the savings, as $10,000 would be needed to pay for the trip (the special dividend). The person's balance sheet would now be the following:

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

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

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

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

Let's nail down two points from this exercise:

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

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

The 'Capital Appreciation' scenario is rather easy to understand. The person generated $25,000 in after-tax earnings (cash flow), added some of it to savings and repaid some debt, and therefore, he/she has increased his/her personal financial situation. The second scenario, or the 'Capital Appreciation+Dividend,' scenario is not as clear. The personal financial situation has increased $15,000 because of the "cost" of the personal dividend. However, the personal dividend is still a source of return because the person very much enjoyed the trip to the south of France, much like shareholders very much may enjoy a special dividend.

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

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

*Nelson on Bogle...*continued on page 10

Simulated Best Ideas Newsletter Portfolio

New for 2018! See page 9.

By Valuentum Analysts

SIMULATED BEST IDEAS PORTFOLIO -- as of December 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	7	$199.00	0.87	17-Jun-11	51.92	54	2,817.63	173.97	9,394.38	1,380.65	3.8%	282.4%
Altria Group	MO	8	6	$58.00	1.24	28-Jun-11	28.39	78	2,228.73	71.67	5,590.26	2,621.41	2.2%	268.4%
Berkshire Hathaway	BRK-B	6	6	$183.00	1.08	20-Apr-16	146.13	69	10,089.97	197.78	13,646.82		5.5%	35.3%
Cisco	CSCO	9	7	$42.00	0.91	14-Nov-14	26.33	221	5,831.87	38.19	8,439.99	525.11	3.4%	53.7%
CVS Health	CVS	9	4	$88.00	0.83	6-Jan-17	81.84	79	6,472.36	73.08	5,773.32	158.00	2.3%	-8.4%
Dollar General	DG	4	7	$89.00	1.02	13-Apr-17	68.83	50	3,448.50	90.93	4,546.50	26.00	1.8%	32.6%
Energy Select SPDR	XLE	NR	NR	NA	NMF	6-Oct-15	67.14	143	9,608.02	68.72	9,826.96	568.61	3.9%	8.2%
Facebook	FB	6	7	$219.00	0.82	29-Jan-16	136.15	92	12,539.34	180.18	16,576.56		6.7%	32.2%
General Motors	GM	6	7	$43.00	0.95	26-Aug-16	31.65	132	4,184.80	40.95	5,405.40	250.80	2.2%	35.2%
Gilead Sciences	GILD	7	7	$109.00	0.69	31-Jul-17	76.32	61	4,662.52	75.57	4,609.77	63.44	1.9%	0.2%
Google - Class C	GOOG	10	6	$1147.00	0.93	23-Oct-12	450.92	7	3,170.42	1064.19	7,449.33	10.35	3.0%	135.3%
Google - Class A	GOOGL	10	6	$1147.00	0.93	4-Apr-14	Split	7	Split	1072.00	7,504.00		3.0%	+++
Health Care ETF	XLV	NR	NR	NA	NMF	22-May-12	36.60	125	4,582.00	83.70	10,462.50	640.49	4.2%	142.3%
Intel	INTC	6	5	$48.00	0.93	12-Sep-11	20.48	150	3,086.50	44.56	6,684.00	796.35	2.7%	142.4%
Johnson & Johnson	JNJ	6	7	$130.00	1.10	29-Jan-16	104.18	54	5,632.72	142.46	7,692.84	349.38	3.1%	42.8%
PayPal	PYPL	NR	6	$58.00	1.30	17-Jul-15	Spin-off	100	Splt	75.65	7,565.00		3.0%	+++
Priceline	PCLN	10	3	$2018.00	0.87	26-Feb-15	1239.49	3	3,732.46	1760.00	5,280.00		2.1%	41.5%
SPDR S&P Dividend ETF	SDY	NR	NR	NA	NMF	20-Apr-16	81.33	124	10,091.92	93.77	11,627.48	379.37	4.7%	19.0%
Utilities Select SPDR	XLU	NR	NR	NA	NMF	18-Mar-14	41.12	83	3,419.96	55.02	4,566.66	469.85	1.8%	47.3%
Verint Systems	VRNT	6	6	$50.00	0.84	13-Apr-17	38.95	87	3,395.65	41.85	3,640.95		1.8%	7.2%
Visa	V	7	6	$91.00	1.25	30-Nov-11	26.86	188	5,064.39	113.82	21,398.16	492.41	8.6%	332.2%
Latest changes: Removed UNP (8/18), Halved AAPL (8/18), Halved PCLN (8/18).														
Cash -- changes in monthly cash balance reflects dividends received and trading gains/losses, where applicable.											71386.23		28.7%	0.0%
Bearish														
For investors seeking 'short' or 'put option' exposure, please consider firms with VBI ratings with 1 and 2 as ideas.														
Best Ideas Portfolio Value								Original -->	100,000.00	Current -->	**249,067.11**			**149.1%**
S&P 500 Index (SPY)						17-May-11	132.69	754	100,000.00	266.51	200,851.61	18,471.20	91.6%	
Cash											18,471.20		8.4%	
Benchmark Portfolio Value											**219,322.81**			**119.3%**
Relative Outperformance														**29.7 pts**

Data as of December 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.

Taking Care of Our Members

We're excited about what's in store for 2018 and beyond, and here are a few things to look forward to!

By Brian Nelson, CFA

NEW for 2018

We are expanding and optimizing our stock coverage. In addition to the 16-page stock reports, dividend reports, and ETF reports, we will now be publishing more thematic coverage in pdf fashion on the stock and ETF symbol pages. This will allow us to provide even more breadth of coverage as we continue to focus on enhancing the depth of analysis. We believe this optimization will be a valuable improvement for members, regardless of which membership plan you are on.

We are launching a brand-new High-Yield Dividend Newsletter and accompanying simulated portfolio, the first edition is planned for release January 1, 2018. We're going to be looking for some of the biggest (and strongest) yields on the market and putting them in a simulated income portfolio. Reserve your membership to this add-on monthly newsletter today. Contact us for more details.

We are optimizing how we communicate our best ideas in the Best Ideas Newsletter portfolio and how we communicate our best dividend growth ideas in the Dividend Growth Newsletter portfolio.

> We think we can better rank our best ideas and best dividend growth ideas in a list for these newsletters. Visa (V) is a prime example as to why we will be migrating to list format with these two newsletters. Its stock continues to reach new highs, but even though it is the top-weighted stock in the Best Ideas Newsletter portfolio, many may not take that to mean it is one of our very favorites.
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> The lists, which will include ideas currently in the respective simulated newsletter portfolios, will begin with the editions of the Best Ideas Newsletter and Dividend Growth Newsletter in January 2018. We will close the calculations of the simulated Best Ideas Newsletter portfolio and simulated Dividend Growth Newsletter portfolio effective December 31, 2017.
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> We will publish analysis of the Best Ideas Newsletter and Dividend Growth Newsletter simulated portfolios in the coming months, and we'll continue to direct our attention to the existing ideas currently in the simulated portfolios, but the portfolios will now be in list format. Stocks will still be added and removed from the lists as needed, so you won't miss any changes in our thoughts or theses on ideas.
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> **The goal of the Best Ideas Newsletter list will be to source interesting ideas with capital appreciation potential from within our coverage universe.** The goal of the Dividend Growth Newsletter list will be to source interesting ideas with strong dividend-growth potential from within our coverage universe. [Please evaluate our new High Yield Dividend Newsletter for higher-yielding ideas.]

We are launching a new data product that combines our archived data into one document. Please contact us if you are interested in receiving this. Many of our members love data, and we have it!

We are very excited about these initiatives, and we hope that you are, too! If you have any questions or concerns, please be sure to let us how we can be of any assistance. Thank you as always for your feedback.

***Nelson on Bogle...*from page 7**

Let's now swap 'person' with 'stock' and make some very important observations. The total return of a stock is tied explicitly to the operations of the company, and more specifically, the future after-tax earnings (cash flow) generation of the firm. A company that does not pay a dividend has greater stock-price capital appreciation potential *than if it were to pay a dividend* because cash is not leaving the company in the form of dividends. Remember: the balance sheet is a source of value, much like a person's savings is a source of value.

A stock that pays out a dividend has lower capital appreciation potential *than if it didn't pay a dividend* because cash is leaving the company in the form of dividends. The dividend is still an important component of return, however. In both cases, however, the company's total return is identical, as total return is explicitly based on the after-tax earnings (cash flow) generating capacity of any entity.

Why This Example Is Valuable

This example is valuable for a number of reasons. First, it shows how value (capital appreciation) is generated via after-tax earnings (cash flows) of the business. Second, it shows how the balance sheet (savings) is a source of value and how using internally-generated cash flows to add to cash on the balance sheet or pay off debt drives capital appreciation potential. And third, it shows how dividend payments impact a firm's capital appreciation potential.

Since dividends detract from the cash that otherwise could have been added to the balance sheet or used to pay off debt, a firm is worth less than it otherwise would be if it had decided not to pay dividends. This dynamic explains why a firm's intrinsic value theoretically should advance at the cost of capital less the dividend yield each year (or the cash flows generated less the cash flows paid out as dividends each year).

Example in Practice

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

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

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

What may be going on in this example? Let's get the more straightforward component out of the way first. The initial dividend yield is 3%, so we know that investors are going to receive 3% of their investment every year, but we really don't know how the price of the investment will perform, *other than it will be 3% lower than it otherwise would had it not paid a dividend.*

For simplicity purposes, let's now talk about the price-to-earnings (P/E) ratio to begin the conversation about returns driven by price changes. We learned that the numerator of the P/E ratio is a discounted cash flow model and that there are a large variety of inputs that can cause changes in the P/E ratio. In Bogle's example, the P/E ratio is expected to increase to 18 times from 15 times over this 10-year period.

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

*Nelson on Bogle…*from previous page

For starters, it is a big "no-no" in the professional investing world to base expectations of future returns based solely on expanding or contracting P/E multiples, but what are some things that might cause this P/E expansion? Well, quite simply, the company could have retained a significant amount of cash over the 10-year period, growing the value of its net cash position on the balance sheet. Just like in the personal balance sheet, more savings (cash) relative to debt is a good thing.

For example, if a company had $20 million in net income and $20 million in net cash at the beginning of the period, the company would be valued at $300 million, using the 15 times multiple (20 million in net income x 15 times). Excluding net balance sheet cash, the adjusted P/E multiple would be 14 times earnings. Assuming earnings grow 7% annually over the 10-year period, the company would record $39.34 million in earnings at the end of Year 10. At 18 times earnings, the company would then be valued at ~$710 million on Year-10 earnings (~$39 million times 18 times = ~$708 million).

Applying a 14-times (ex-cash) PE multiple, which we derived at the beginning of this period, to Year-10 earnings (14 times $39.34 million=~$550 million), this analysis would suggest that the company's net cash balance expanded significantly to ~$160 million (~$708 million less ~$550 million), even as it paid out dividends to shareholders (it has a 3% dividend yield). In this example, just retaining earnings and cash on the balance sheet can drive P/E expansion, even if the core P/E, excluding net cash, multiple did not change.

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

Forward Price to Earnings Ratio =

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

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

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

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

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

Capital Expenditures: Impacts Future Enterprise Cash Flows (Negative)

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

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

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

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

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

Total Cash: Impacts Enterprise Value (Positive)

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

As outlined above, the numerator of the P/E multiple considers a plethora of factors in determining which multiple the market applies to a company's earnings. In this regard, it becomes clear that it is quite silly to make hasty forecasts of price returns on the basis of expanding or contracting P/E ratios. There are simply too many factors to consider to merely expect expanding or contracting P/E ratios. For starters, the calculation of the numerator of the P/E is derived by a discounted cash-flow model, and the resulting

*Nelson on Bogle…*continued on next page

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equity value per share (the output of the discounted cash-flow model) is then divided by future earnings to arrive at what one might consider the true P/E. There's a lot of work involved.

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

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

Wrapping Things Up

Bogle has brought index investing to the individual investor's doorstep, and financial advisors are capitalizing on its low-cost approach in a big way. However, investors have to be very careful not to make future predictions about stock market returns that are simply illogical to justify, and then use those predictions as a reason for indexing. Please be even more careful to understand the true nature of the dividend payment, too.

Critically, dividend payments reduce a stock's capital appreciation potential from what it otherwise would have been under a scenario in which it doesn't pay a dividend. The discounted cash-flow model represents Bogle's second and third components – the earnings (E) and price-earnings (PE) together. Changes in earnings and changes in the P/E collectively represent changes in firm value, and firm value is precisely what the discounted cash-flow model calculates. It doesn't make sense to hastily predict expanding or contracting P/E multiples.

Total return is not augmented by the dividend, in a theoretical and practical sense as shown in the Cracker Barrel example, but the dividend replaces a portion of the capital appreciation component. In the market today, however, this very concept may be being misconstrued. Dividend-paying firms could be receiving higher P/E multiples (rightly or wrongly) because they are paying a dividend, and the very concept of a growing dividend payment may be leading to more capital appreciation, bolstering overall total returns. What an interesting time 2017 is turning out to be -- and mostly because of ultra-low and sometimes negative real interest rates!

In all, however, please don't fall into the trap of thinking that the dividend is incremental return. It's nice to receive the dividend check, of course, but it means the company's balance sheet net cash is just not as big as it could have been (if it didn't pay the dividend), and you now know how important the net balance sheet is to calculating intrinsic value and capital appreciation potential.

*Nelson on Bogle…*continued on next page

Altria Back Above $70, Dollar General Pleases, Verint Sells Off

We were very happy to see newsletter portfolio idea Altria surge back above $70 per share in recent days. Dollar General continues its strength as the economy churns out more of its demographic, and we continue to believe the dollar store arena may be one of the few spaces of retail that is truly insulated from the Amazon effect. Verint Systems, on the other hand, has faced selling pressure, which we think is flat-out unwarranted.

By Kris Rosemann and Brian Nelson, CFA

In case you missed the latest video series, "Off the Cuff" from President of Investment Research Brian Nelson, we've been following very closely developments in North Korea and the Bitcoin markets, but we've also been working hard to get the "right" information and things to be mindful of to readers when it comes to fees and ETFs. All fees matter, and we encourage the financial industry to start reporting fund performance after adviser fees, to provide the individual investor better information. Also, we've long been concerned about the implications of investors thinking they are buying "value" instruments, but somehow end up with an ETF of potentially "overvalued" stocks in the case of when intrinsic-value approaches, namely discounted cash-flow analysis, are not pursued in the instrument's methodology.

We wanted to make sure you're aware of the path to war the US and North Korea appear to be taking, as we outlined in "Off the Cuff." The markets, however, appear to be sleeping, and while this has us concerned given the lack of price discovery that such volatility implies, we're also not shying away from highlighting the strongest of companies. One such company is Altria (MO), an idea in both the Best Ideas Newsletter portfolio and Dividend Growth Newsletter portfolio. We've been very pleased to see its shares skyrocket back over $70 per share in recent days. We've tactically "taken some off the table" recently, but we still very much like the pricing power of its business model even in the face of declining cigarette volumes.

Best Ideas Newsletter portfolio idea Dollar General (DG) is well on its way to its 28th consecutive year of same-store sales growth. In its fiscal 2017 third quarter, report released December 7, the company reported same-store sales growth of 4.3%, driven by an uptick in both customer traffic and average transaction amount. Strength in consumables, seasonal, and apparel categories helped drive net sales to $5.9 billion in the quarter, an increase of 11% from the year-ago period. Through the first three quarters of its fiscal year, Dollar General reported same-store sales growth of 2.6% and overall sales growth of 8.5%.

Dollar General's bottom line fared well in its fiscal third quarter, too, though it did face an earnings headwind of approximately $0.05 per share due to hurricane-related issues. Diluted earnings per share grew to $0.93 in the fiscal third quarter from $0.84 in the comparable period of fiscal 2016, but investors should note the role that a reduction in shares outstanding played in this growth. Net income grew to $253 million in the quarter from $235 million a year earlier, but margins faced pressure as a result of hurricane-related expenses and an increase in retail labor expenses.

Dollar General's free cash flow faced pressure as a result of an increase in capital expenditures, but we like this investment spending (net cash from operations expanded slightly). For one, the company continues to open new stores as well as remodel existing stores at a tremendous pace. Dollar General plans to open ~1,285 new stores in fiscal 2017 in addition to 760 remodels or relocations, and fiscal 2018 is expected to bring the opening of ~900 new stores, remodeling of ~1,000, and relocation of ~100.

The discount retailer's strong fiscal third quarter performance led management to increase its full year top-line guidance and tighten its earnings per share guidance. It now expects net sales growth of ~7% and same-store sales growth of 2.5% on a year-over year basis, compared to previous guidance of 5%-7% for net sales growth and slightly positive to up 2% for same-store sales growth. Earnings per share guidance has been adjusted to a range of $4.37-$4.47 from $4.35-$4.50.

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We do not expect to make any changes as it relates to Dollar General in the Best Ideas Newsletter portfolio. The company continues to impress us with its resiliency in the face of a difficult broader retail environment, and shares look to have room to move higher on the basis of the upper bound of our fair value range, which currently sits at $107 per share. Regardless, Dollar General has been a big winner for the Best Ideas Newsletter portfolio thus far in 2017 as it was added just under $69 per share in April, all while offering investors a ~1.15% yield.

On the other hand, Verint Systems (VRNT) is facing selling pressure that we think is completely unwarranted. The company beat expectations on both the top and bottom line in its third-quarter report, released December 6, and it offered preliminary guidance for the fiscal year ending January 2019. It expects total revenue to advance to $1.215 billion with a range of +/- 2%, while it expects $3 per share in non-GAAP diluted earnings at the midpoint, implying that shares are trading at ~13 times forward earnings in a market where the average S&P 500 company is trading at over 18 times. Plus, Verint is growing like a weed and has tapped into the burgeoning cybersecurity market. We think the market is mostly concerned about the presentation of GAAP versus non-GAAP, but cash flow trends say it all.

Through the first nine months of the fiscal year, Verint Systems has pulled in $96.2 million in net cash from operating activities while it has spent $26.4 million in property and equipment, implying healthy free cash flow (it has also grown year-over-year). The company does have a net debt position, but it also has substantial liquidity, with ~$313 million in cash and cash equivalents. Long-term debt of ~$766 million isn't overbearing either given cash-flow generation and growth prospects. Verint still looks cheap to us on both a forward earnings multiple basis and on a discounted cash-flow basis, and the company is tied into the growing cybersecurity market, an open-ended opportunity. Here's what Verint had to say in the third-quarter press release:

> In Cyber Intelligence, we are a market leader in security and intelligence data mining software and **we are pleased with our double-digit year-over-year revenue growth for the third consecutive quarter this year**. Our results reflect the demand for solutions that can address terrorism, crime, cyber-attacks, and other threats that remain pervasive around the world. We believe our broad portfolio, domain expertise and on-going innovation will contribute to sustained long-term growth.

We think "the shorts" are beating up a stock that frankly doesn't deserve it. In any case, we like what we're seeing across both newsletter portfolios, Dollar General continues to act well, and it was good to see Altria spring back to life. Most of the fee-based market is going to tell you to ignore everything and keep your money with them, but that's why we're independent. We have the unique privilege to tell you about the real risks, not only with respect to the geopolitical environment but also with respect to overall valuations and what we think is simply irrational behavior by many stock market participants. Please keep paying attention to preserving your hard-earned savings. Don't let complacency cost you big!

Comment: Verint's Traditional Free Cash Flow

Verint is free cash flow positive, implying that non-GAAP earnings adjustments are of high quality.

By Kris Rosemann and Brian Nelson, CFA

Q: What are your thoughts on this bear case for Verint Systems? "Verint's Profits Don't Justify Its High Valuation"

A: We're somewhat puzzled by the financial analysis of the write up, perhaps most with the author's calculation of free cash flow, which may not truly reflect the goings-on of the cash flow statement (the author defines free cash flow as NOPAT less the change in invested capital).

Adjustments to free cash flow are typically made within the valuation context (as NOPAT less the change in invested capital may do), but such valuation-adjusted metrics are not always as informative in

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assessing the "true" cash flow characteristics of the business, outside the valuation context. For example, traditional free cash flow is measured as cash flow from operating activities less additions to property plant and equipment (or capital expenditures).

Verint is not burning through cash as the article noted. Traditional free cash flow for the company in fiscal 2017, for example, came in at more than $140 million. Though we very much understand the merits of making important adjustments to cash flow items within the valuation context, traditional free cash flow is a rather straightforward concept, and Verint's is positive.

	Verint Systems Free Cash Flow			
($ in millions)	2015	2016	2017	2018*
Cash From Operations	$194	$157	$172	$96
Capital Expenditures	29	30	30	27
Free Cash Flow	$175	$127	$143	$69
Free Cash Flow Yield	15.5%	11.2%	13.4%	8.4%
*fiscal year ends January 31; 2018 results through three quarters				

Source: Verint's regulatory filings

Verint's fiscal 2018 non-GAAP earnings per share guidance is $2.75 per share, and management's early projection for fiscal 2019 non-GAAP EPS is currently $3.00. Consensus estimates for fiscal 2018 and 2019 are $2.75 and $3.03, respectively, implying that shares are trading at ~14 times on a forward basis (a rare bargain, especially for a company that is growing the top line). We think it's also worth noting that the meaningful adjustments to GAAP net income (aside from stock-based compensation) to arrive at GAAP net income are acquisition related, the largest being amortization of acquired tech and intangibles, as well as restructuring expenses. We generally view these as transient adjustments that warranted the non-GAAP treatment, a notion we feel is supported by relatively stable operating cash flow and free cash flow.

Said differently, if Verint didn't have such strong traditional free cash flow performance, we'd be mighty concerned about the GAAP versus non-GAAP discrepancy, but the company does have strong traditional free cash flow performance, implying that non-GAAP earnings are not low quality. Of course it is important to focus on various measures of free cash flow as it relates to calculating the intrinsic value of a company (within the valuation context), but valuation adjustments are not always clean, and they shouldn't necessarily be used to explain the core goings-on of the business. We may be "right" or "wrong" with our Verint idea, but it won't be because of GAAP or non-GAAP reasons, or even cash flow valuation adjustments. We maintain our view that Verint's shares are underpriced.

How to Think About Corporate Tax Reform

Donald Trump and team are working hard to "Make America Great Again," and lowering tax rates on corporations is a key initiative. Nobody knows for sure whether such efforts will come to fruition, but knowing how to use our research and understanding the fair value estimate range puts you ahead of the crowd, if it hasn't already.

By Brian Nelson, CFA

It's on everyone's minds these days. What is it? Taxes.

On November 16, the House gave the thumbs up to what the New York Times described "as the most sweeping tax overhaul in three decades," and it is now set for a final vote in the Senate as well. The bill aims to cut the corporate tax rate to 21% from 35%, and reduces the number of tax brackets from seven down to four: 12%, 25%, 35%, and 37%. The Senate will be looking to get its version of the bill passed after the Thanksgiving holiday, but it may be too early to say whether the bill in its existing form will get the job done.

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Some are saying the proposed new tax legislation might actually raise taxes on lower-income Americans within just a couple years, and while the "real" story varies depending on which side of the aisle you're talking to and what assumptions you make, we're optimistic tax reform has a real chance, though we note Congress has a way of stopping itself dead in its own tracks, much like recent efforts with respect to healthcare reform. Republicans, in any case, would like a bill on President Trump's desk before Santa arrives, and Trump has since promised, "giant tax cut for Christmas." That might be an optimistic timeline, but we'll see. We'd be fools to try to handicap the political environment, but we can't ignore it either.

Our efforts continue to be spent on thinking about how any changes in the tax code may impact corporate valuations. Our fair value estimates across our coverage currently reflect what we consider to be a base-case valuation for the respective stocks, and we provide a fair value estimate range, in part for you to ascertain how items like a permanent reduction in the corporate tax rate or permanently low discount rates (the 10-year Treasury) might impact a company's valuation. You might consider the upper bound of a fair value estimate range as a new "base case" in the event corporate tax rates are reduced to 21% and interest rates remain artificially low into perpetuity.

Some companies might even see larger point fair value estimate adjustments and some smaller, but this is one of the key benefits of having access to our discounted cash-flow models. You can enter your own cash tax rate assumption and see how that impacts the valuation of the equity you're interested in. The change will reflect the net impact of higher future free cash flows, offset in part by a higher after-tax cost of debt, where applicable. At this point, we're putting the odds of meaningful corporate tax reform around 50/50, as we're not partial to any information that would lead us to believe chances aren't even.

We're anxiously awaiting the outcome, but we're not getting too excited. The market has been expecting "something" with respect to changes in the tax code for some time. We may make changes here and there to our point fair value estimates in our coverage universe in the event corporate tax reform eventually does become law, but for the most part, we think our fair value estimate ranges continue to capture what they are supposed to. Our base cases reflect forecasts that capture a favorable political and economic environment to corporations, the high end of the fair value estimate ranges might capture a continuation of ultra-low interest rates and beneficial corporate tax reform, and the low end of the fair value estimate ranges might signal a deteriorating political environment and a recession that nobody is currently predicting.

During the past year, we've given many companies cost-of-capital benefits as a result of their respective all-equity structures to better reflect what we'd describe as lower financial/bankruptcy risk, particularly in the event of the current ultra-low interest rate environment. Frankly put, some of our cost-of-capital assumptions had been too high as a result of the Fed seemingly taking its queue from the stock market more than anything else. We're still mindful of the potential rising capital costs for more leveraged entities in the event operational cash-flow sours during tough times, of course, but the Fed isn't moving as quickly as we would have thought given stock market prices and the strength of the US economy. It couldn't have been 15 years ago when a prudent saver could get a certificate of deposit interest rate of 7%. Now look at how much risk one has to take on to get that yield!

What's the Fed doing? It has almost backed itself against the wall, making it necessary to support the stock market just to keep savers from losing years and years of income. Still, the recent past has shown the Fed doesn't have to raise rates aggressively. There's a lot going right in a lot of places in the economy right now, especially unemployment--and the wealth effect of the stock market has been tremendous on consumer spending. Jokingly, I'm hearing that people are buying Teslas after having cashed in their Tesla (TSLA) stock. Why should the Fed ruin a good thing? Of course, all good things eventually come to an end, and the savviest of investors are the ones that are most worried, but who wants to be responsible for sending the market into a tailspin? The Fed certainly doesn't.

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In any case, the answer to how corporate tax reform may impact the valuation of companies in your portfolio is in each company's 16-page report, as it relates to the high end of the fair value estimate range, which we think is a good estimate in the event corporate tax reform comes to fruition. You can download our latest weekly data update here, which always includes the upside and downside cases, and please let us know if you'd like to use our discounted cash-flow models to put in your own cash tax rate assumption to evaluate the impact. We think this is one of the biggest benefits of our service. Within the discounted cash-flow model, you can assess and consider probabilities with the simple stroke of the keyboard. Having access to our discounted cash-flow models is a key part of the financial advisor level and institutional level plans.

CVS Health at the Crossroads, Too Much Debt

We have been disappointed with the lack progress displayed by CVS Health thus far in 2017. We knew the business was entering into an earnings trough as a result of key contract losses, but recent events have unfolded that, in our view, have lessened the attractiveness of its business model, to a meaningful degree. Let's talk more about what's happening at CVS Health, the changing PBM market, Amazon's threat, and too much leverage. We're not overreacting, but we're not happy either.

By Alexander J. Poulos

CVS Health hasn't performed as we would have hoped during 2017, and frankly, it has been hit by a storm of negativity, not the least of which has been caused by the disruptive threat of Amazon. Though we can point to some huge winners in the Dividend Growth Newsletter portfolio this year, brand new ideas like Boeing, for example, it always gets to us when we are blindsided by abruptly-changing business fundamentals. We almost want to scream foul! In business as in life, however, things change, and that's just how it is. We're not happy about recent developments at CVS Health, especially its plans to balloon its balance sheet (and the implications on dividend health), but we're not going to hide our concerns under the rug either. Let's talk it through." – Brian Nelson, CFA

Background on the PBM Business

The pharmacy benefits management (PBM) business remains the crown jewel of CVS Health as the unit continues to post year over year growth. However, in recent months, the PBM business may have entered a critical inflection point with negative implications for the integrated model of CVS and the pure play model of Express Scripts (ESRX). We're not overreacting, but we think you should be aware of potential structural shifts.

The trend of outsourcing prescription benefits management to outside vendors has come under fire with Anthem (ANTM) publicly claiming that Express Scripts has systematically overcharged them over the course of the contract post the acquisition of Anthem's PBM unit by Express Scripts. We had anticipated Anthem would move its considerable PBM business over to a competitor once the contract lapses in January of 2020, but we're now surprised Anthem decided to form its own PBM named IngenioRX. Fortunately for CVS, it was "lucky" enough to gain a contract to help manage the PBM upon launch. However, we feel once the contract lapses in 2024, Anthem may convert to a 100% in-house operation, thus further narrowing the field of potential clients that CVS can service.

Also, it is important to keep in mind that United Healthcare (UNH), the largest managed care company in the US, showed incredible vision by setting up its own internal PBM dubbed OptumRx, which has directly aided in the stellar profit growth displayed by United Healthcare over the past five years. The size of United coupled with the growth of Optum is a dual edge sword for CVS as it deprives them of a large potential customer base while further narrowing the pool of possible covered lives thus restricted likely new growth of the PBM business. We were initially optimistic that Anthem would migrate its business over to CVS Health, but the move to form IngenioRX, in our view, places considerable doubt as to the ability of the PBM market as a whole to grow—and this is before we account for the disruptive threat that is Amazon (AMZN).

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In our opinion piece "Opinion: Is Amazon Prepared to Tackle the Pharmacy Market?" we discussed the probability of Amazon entering into the PBM business.

> With over 300,000 employees and a commanding lead in cloud computing, a credible case can then be made for Amazon to build its own internal PBM. As a result, we feel it may be a bit premature to anticipate Amazon will enter the PBM market outside its internal needs, at least at this time.
>
> Quote Attributed to Alexander J. Poulos

Let's review the PBM angle for a moment. Amazon is one of the top ten employers in the US, which in our view, nearly ensures that Amazon will set up an internal PBM in a similar vein as Anthem to service its employee healthcare needs. CVS on a recent conference call signaled it is willing to partner with Amazon. The best case scenario, in our view, is a short-term contract similar to the IngenioRX deal to aid in implementation. However, once the contract lapses, Amazon will retain full control of the division, thus maximizing the savings.

It seems the independent PBM business model may be ripe for disruption with the nation's largest healthcare insurers looking to develop in-house solutions in an effort to rein in costs. It's growing likely that perhaps a few key defections may pressure profits of PBM's, especially if, for example, large corporations such as General Electric (GE) and IBM (IBM) decide to accept the in-house PBM's offered by United Healthcare and Anthem. The comprehensive package that can be provided could prove to be more cost effective, and if so, this could potentially start a negative chain of events for the independent PBMs. Let us be clear, however—we think there will always be a place in the market for a PBM, but with the new evidence presented, the in-house versions are the latest trend that could severely hamper future profitability of Express Scripts and the Caremark division of CVS Health.

Drug Distribution

CVS' pharmacy network continues to feel the strain of contract losses coupled with reimbursement pressures. The loss of a few key contracts has had an outsize impact on the company as the pharmacy business remains burdened with high fixed costs, meaning the last few Rx's filled are the most profitable (it is a case study of a volume based business-->an increase in volume leads to an increase in profitability due to higher incremental margins). Thus far, the pharmacy network has not revealed the strain of being associated with the PBM unit as competitors have not excluded CVS Pharmacy in no small degree from its network of providers. We suspect the likelihood of this dynamic changing is high, especially if Amazon enters the brick-and-mortar pharmacy space. In our opinion piece, "Opinion: Is Amazon Prepared to Tackle the Pharmacy Market?," we discussed the implications of Amazon entering into the retail pharmacy business:

> If Amazon were to begin contracting with other corporations to provide PBM services, Express Scripts with its lack of local pharmacies remains highly exposed. The Caremark division would also suffer, even as the pharmacy field evolves toward a point-of-care service in addition to dispensing medications.
>
> For Amazon to fully hamper CVS, it would need to build out a cluster of stores, which it has resisted thus far. The Amazon Go supermarket concept, however, could be considered the first shot across the bow, as it is Amazon's attempt to break into the grocery store market. If Amazon were to proceed with a roll-out of the Amazon GO concept, a credible case could be made the entire Drug Delivery Model could be at risk assuming Amazon equips its supermarket concept with a pharmacy department. Amazon is also now opening brick-and-mortar bookstores, a headache for Barnes & Noble (BKS), but nonetheless, more evidence that Amazon continues to evolve.
>
> Quote Attributed to Alexander J. Poulos

The fall in Rx volume during CVS Health's third quarter continues to pressure front-end sales, which posted a drop of 2.8% for the recently completed period. We feel the front end with its traditional assortment of

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products ranging from hair and oral care to convenience store staples such as beer, soda, and candy may be exposed to the potential for continued declines. The footprint of the traditional CVS store has a tremendous amount of space dedicated to these products, which are often priced at convenience store rates if not on sale.

On a recent conference call, CEO Larry J. Merlo attributed some of the decline in front-end sales to a more nuanced pricing strategy. We're reading this as the company has abandoned utilizing high turnover products such as soda sold at a loss to drive front-end sales. While we agree the focus of the stores should not be on becoming another retailer, it begs the question—is the store's physical footprint way to large for the current evolution of the business? This could become tremendously problematic over the long haul, as we've seen across the retail space, especially those of the big box variety.

CVS Bringing On Too Much Debt with Aetna Deal

Though we understand why CVS Health may want to act quickly in response to changing industry dynamics, we haven't been pleased with the pending acquisition by CVS Health of Aetna (AET). There are other reasons for the transaction, of course, but we feel the overture is a defensive move enacted from a position of weakness that if consummated will blow a massive hole in the combined entity's balance sheet. Here's what we said more recently in our October piece, "CVS Health Under Review…:"

> *We probably were least-of-all pleased with having learned about the acquisitive nature of CVS Health in its bid for Aetna for no small sum, reportedly over $200 per share ($66 billion). Having also talked to Anthem and United Health, CVS Health is clearly on the defensive following Amazon's foray into the pharmacy space. However, launching a huge acquisition such as one with Aetna, one that might bury the company in debt while its operations could be squeezed on the margin, makes for a rather ominous scenario, at the very least with respect to the long-term health of the dividend. – October 31, 2017*

Aetna's current market cap of ~$60 billion is somewhat in-line with the ~$73 billion dollar market cap of CVS Health (both figures at the time of this writing). **For CVS Health to fund the acquisition, it would assume an enormous amount of debt right at the time when the core business is being disrupted.** From Aetna's perspective, the acquisition would catapult the combined entity to be on par with United Healthcare's offerings, as CVS-Aetna would gain a world-class PBM coupled with an extensive pharmacy network which the entity could, in theory, transform into point of care service centers.

If we assume the deal comes to fruition, we might advocate for a broad, but costly transformation of the store base, whereas the front end would be shrunk at minimum to half its size with the remaining sales floor converted to a full-service medical clinic with onsight lab testing in addition to a physician on staff to treat the community. Aetna could leverage its extensive customer network by offering incentives via lower co-payments, if members utilize the clinical services available at the newly formulated CVS, which are conveniently located in high traffic areas.

There are a few challenges to this theory, the primary one being the expansive footprint that is CVS. We feel a re-imaging of a portion of the store base would be adequate to drive the gains needed for Aetna which leaves the question: what do you do with eh remaining store base? Would it not be more cost effective to partner with Walgreens (WBA) whose footprint is just as vast with a similar set-up while avoiding the debt taken on from such a deal?

The overriding question posed by such a transformative transaction is: when can we expect the deal to become accretive to earnings or accretive to value-generation? We feel such a combo would require a long lead time, possibly over two years with a broad assumption of potential synergy targets that may not manifest themselves. The sell-off in shares of CVS post the rumor of such an ambitious deal may unfortunately be the correct knee-jerk response, as the transaction may transform the CVS "story" into one where debt service management becomes more the norm than dividend expansion.

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Terms of the CVS-Aetna Deal

On December 3, CVS Health entered into a definitive agreement to purchase Aetna. The terms of the deal are very favorable to Aetna shareholders, as CVS is willing to pay $145 in cash in addition to 0.8378 shares of CVS Health equity for each outstanding share of Aetna. The significant cash outlay may be necessary to gain Aetna shareholder approval as the equity portion of CVS may feel the impact of the enormous debt load placed on the balance sheet in order to close the deal.

CVS is funding the $69 billion transaction via the combination of $4.1 billion in cash on hand, the issuance of an additional $21 billion in equity, and a whopping $44.8 billion in new debt. We are not at all happy with CVS blowing up its balance sheet to make such an audacious purchase. The new debt on the books will balloon the Newco's debt/EBITDA ratio to 4.6x versus the prior 2.1x debt/EBITDA thus in our view ransforming the company from a cash-rich entity to a highly leveraged play on the potential transformation of the US healthcare system.

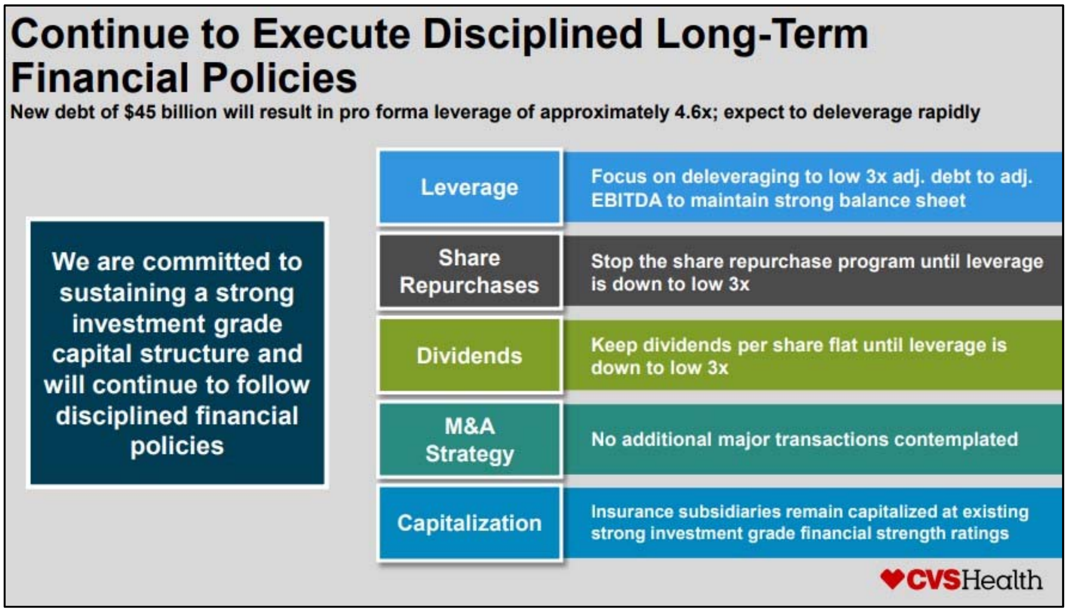

Image Source: CVS Health Conference Call Slide Deck on December 4

From an income investor's perspective, the deal could likely be considered a disaster as the debt load may severely curtail the capital returns offered to shareholders. The abundant free cash flow that we were initially attracted to may face pressure, too, as CVS' new priority--in addition to radically reshaping the US Healthcare system (a daunting task)—will be to deleverage. One of the main appeals of CVS Health had been the rapidly-growing dividend coupled with a low payout ratio—an excellent combination that bodes well for continued well above the rate of inflation dividend hikes.

However, the debt burden that would be placed on the balance sheet, if the proposed deal would come to fruition, has effectively torpedoed one of CVS Health's main draws. David Denton, the CFO of CVS Health, mentioned on the conference call his expectation of lowering leverage into the mid-three range by year two which we interpret to mean limited dividend hikes or share repurchases (or none at all) for roughly three years as CVS Health attempts to work off the debt. We're not happy at all.

Synergies of the Transaction

One of the most overused (dare we say abused term on modern finance) "synergies" was trotted out at on the conference call. Unfortunately, we also weren't very happy with the seeming lack of meaningful potential synergies as the proposed $750 million in "synergies," if achieved, would kick in year two after the approval of the deal. We are looking at a mid-2020 event assuming the deal closes in mid-2018 as

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projected. Denton further clarified the synergy expectations in the following quote:

> On the $750 million synergies, there's virtually **no revenue synergies** tied to this. This is **mostly cost** and a little bit of, I'll say, care management synergies as we think about getting -- or helping consumers get the lowest-cost site of care for the most part. So I wouldn't think about this as revenue synergies at this moment. I do think longer term, there are opportunities to grow revenues as we think about the enterprise and all the capabilities that we'll have here. As it relates to the permanent financing and the cost of that debt, it will depend a bit about the tenor in which we place our portfolio. But you would think about it probably in the 4% ZIP code is our current thinking. That could wiggle a bit based on the amount of short- versus long-term debt that we ultimately place at the end of the day. – Quote Source: CVS Health

We weren't impressed with this explanation, as we feel CVS has to work to fend off a potential Amazon challenge, and bulking up to try to defend its turf as Amazon may make the most sense (not cutting back). We get the distinct impression that CVS fears the lucrative PBM business may get much smaller as the two largest managed care organizations (MCO) in United Healthcare and Anthem are now insourcing the PBM business with others looking to emulate the model. We continue to believe the Amazon threat is real, but not the primary reason for the merger. In short, CVS is attempting to remain relevant in the PBM space by acquiring an MCO it feels will allow the company to perhaps emulate the United Healthcare model.

Integrated Health Care Model

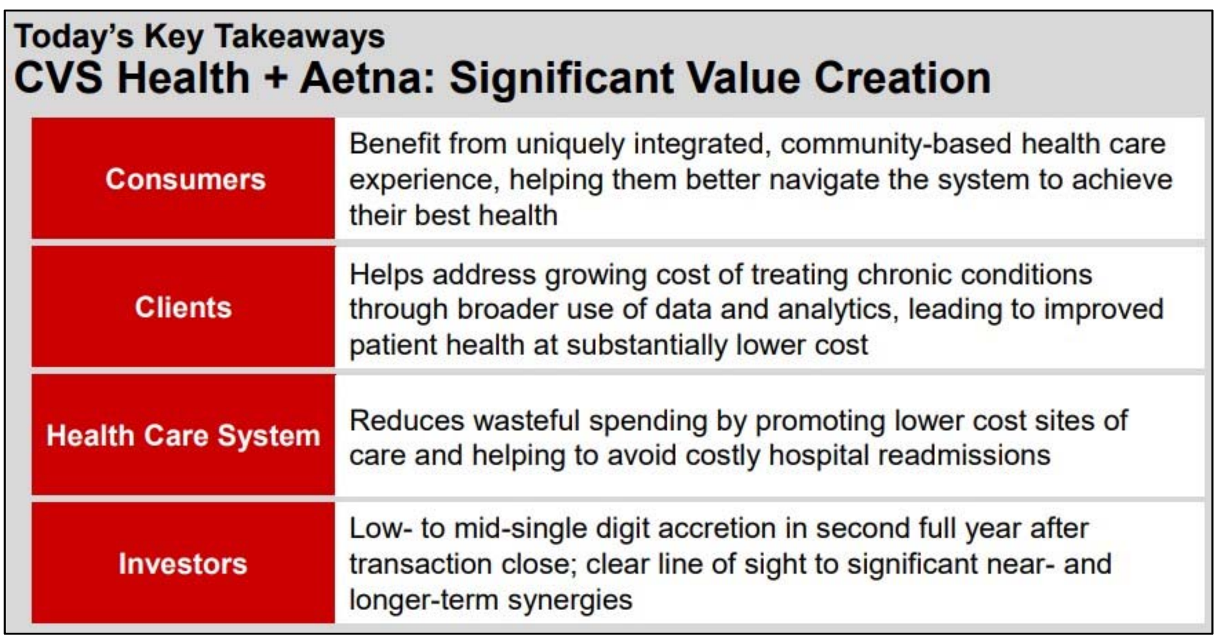

Image Source: CVS Health Conference Call Slide Deck on December 4

Let's examine, in depth, a bit more each of the four potential points of significant value creation.

First, CVS is proposing consumers will benefit from an easier-to-navigate health system via this merger. We find the statement as highly speculative as other integrated models have failed miserably. We cite the acquisition of Health Care Partners by Davita (DVA) as the prime example of a recent colossal integrated healthcare system failure. Davita runs an excellent dialysis business, but the adroit management team has met its match via the acquisition of Healthcare Partners. The original goal had been to create a seamless patient experience for Davita's critically ill patient population. The results for Davita have been somewhat embarrassing as the acquisition remains an unmitigated disaster. Still, Davita shares have

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sprung to life on a report it is looking to exit the business and focus exclusively on being the dialysis provider of choice. We are highly skeptical the diverse patient population that is covered by Aetna will seamlessly blend into this integrated care model.

We were also perplexed by the commentary of lowering the cost of chronic conditions as the data in question is already at the fingertips of both companies. When a claim for a medication is adjudicated to the third party (in this case Aetna), an electronic record is created which is issued to pay for the medication—hence, Rx billing is immediate versus care at the physician's office, which may take weeks before a bill for service is provided. CVS, via its extensive database, already has this information, as does Aetna, via the collection of data each time an Rx is filled. We doubt additional meaningful insights will be gleaned outside of perhaps data from patients that are covered by a competing plan.

We are intrigued by the potential for the repositioning of the physical CVS store footprint away from its current format as a pseudo-convenience store into a more healthcare-centric outfit. We can easily envision a shrinking of the sales floor to free up space to construct offices for healthcare workers such as physician assistants, nurse practitioners, a lab in addition to the traditional doctor. We do believe it may help defray some costs, but the goal of reducing hospital admissions, in our view, will remain elusive under the current healthcare rules. Due to lack of readily accessible urgent care centers, many have utilized the emergency room as a primary care center which is easily the most expensive care available. We feel the clinics that may be built in the CVS stores will not be staffed on a 24-hour basis. Thus, it may eliminate some yet far from enough of these non-emergency visits to the emergency room.

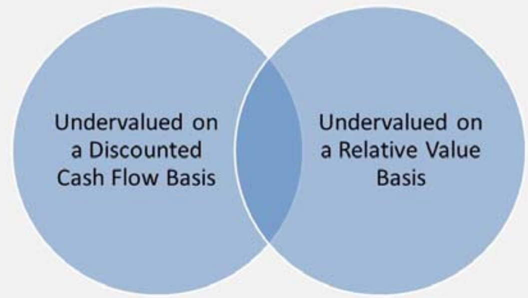
Conclusion

As you can probably gather by now, we are not fans of CVS' proposed merger of Aetna (even as we say the deal is great for Aetna shareholders looking to cash out). The audacious goal of purchasing Aetna diminishes a significant portion of the once-attractive idea that was CVS Health. The lack of a substantial capital return potential, plus the enormous debt load is taken on by CVS Health, has us looking for the exit. If the merger had not been announced, CVS had the potential to ride the recent wave of good fortune in retail higher, especially given November 2017 comparable store trends at Costco (COST), for example. We're watching the chart (the technicals) to see if we can find an exit point that still might make CVS a winner. Long term, however, we won't be sticking around.

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	Price / Fair Value	Fair Value Estimate
R.R. Donnelley	RRD	UNDERVALUED	NEUTRAL	0.58	$17.00
Apple	AAPL	UNDERVALUED	NEUTRAL	0.80	$199.00
Weatherford Intl	WFT	UNDERVALUED	NEUTRAL	0.56	$7.00
Western Union	WU	UNDERVALUED	ATTRACTIVE	0.76	$25.00
Cardinal Health	CAH	UNDERVALUED	NEUTRAL	0.71	$83.00
AIG	AIG	UNDERVALUED	ATTRACTIVE	0.85	$78.00
Huron Consulting	HURN	UNDERVALUED	NEUTRAL	0.76	$48.00
AMC Networks Inc	AMCX	UNDERVALUED	ATTRACTIVE	0.79	$75.00
Cisco	CSCO	UNDERVALUED	NEUTRAL	0.77	$42.00
Sally Beauty	SBH	UNDERVALUED	NEUTRAL	0.71	$22.00
Gilead Sciences	GILD	UNDERVALUED	NEUTRAL	0.73	$109.00
SunPower	SPWR	UNDERVALUED	NEUTRAL	0.47	$15.00
Nautilus Inc	NLS	UNDERVALUED	ATTRACTIVE	0.75	$17.00

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

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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.

Due to the frothy stock market environment, which is driving up valuations, there are no stocks that register a 9 or 10 on the Valuentum Buying Index rating system at this time. **Please consult the Best Ideas Newsletter portfolio on page 8 for our best ideas.**

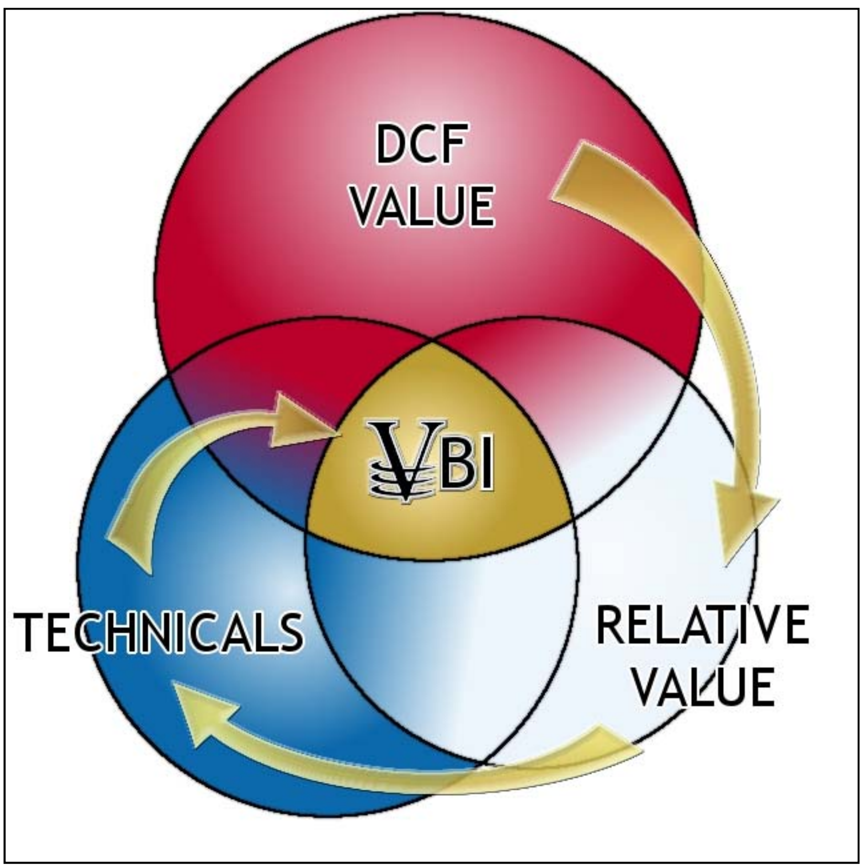
Company Name	Symbol	Sector	VBI
National Beverage	FIZZ	Consumer Staples	1
Ecolab	ECL	Materials	1
Quidel Corp	QDEL	Health Care	1
Badger Meter	BMI	Industrials	1
J&J Snack	JJSF	Consumer Staples	1
Lancaster Colony	LANC	Consumer Staples	1
Clorox	CLX	Consumer Staples	1
Toro Co	TTC	Industrials	1
Bio-Rad	BIO	Health Care	1
Universal Health Realty	UHT	Financials	1
National Instruments Corp	NATI	Information Technology	1
Netflix	NFLX	Consumer Discretionary	1
South Jersey	SJI	Energy	1
Raytheon	RTN	Industrials	2
Teledyne	TDY	Industrials	2
Northern Trust	NTRS	Financials	2
Praxair	PX	Materials	2
Harris Corp	HRS	Information Technology	2
TriMas Corp	TRS	Industrials	2
Trimble	TRMB	Industrials	2
Amphenol Corp	APH	Information Technology	2
Navigators Group	NAVG	Financials	2
Jack Henry	JKHY	Information Technology	2
World Wrestling	WWE	Consumer Discretionary	2
Estee Lauder	EL	Consumer Discretionary	2
Graco	GGG	Industrials	2
RBC Bearings	ROLL	Industrials	2
Aspen Technology	AZPN	Information Technology	2
VeriSign	VRSN	Information Technology	2
Consolidated Edison	ED	Energy	2

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.



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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.

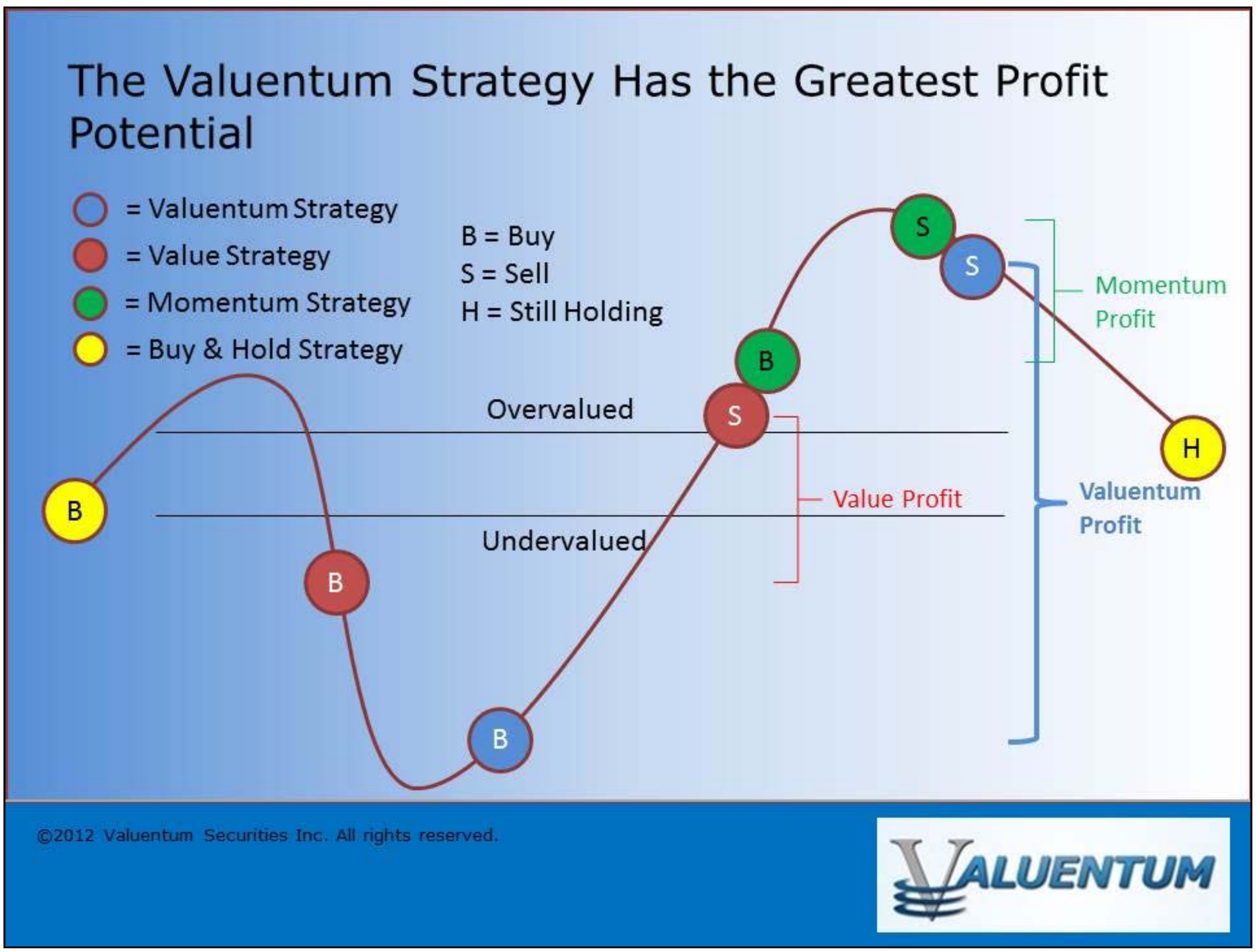

Illustration for educational purposes only.

Our Methodology – The Valuentum Buying Index continued on next page

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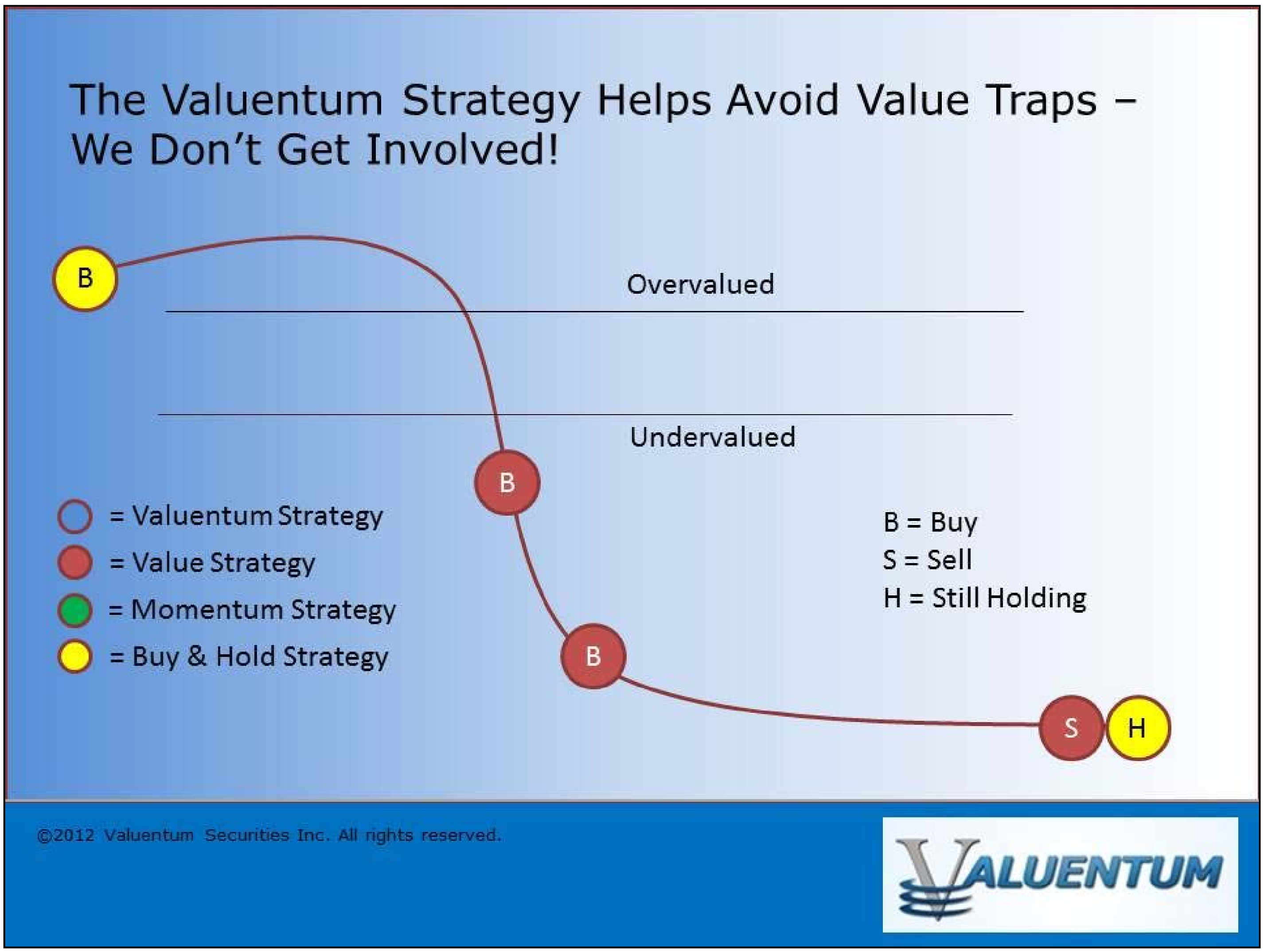
Furthermore, we think Valuentum subscribers are less likely to be involved in so-called value traps because we demand material revenue and earnings growth for firms to earn a 10 on the Valuentum Buying Index. Value traps often occur as a result of secular declines in a firm's products or services, resulting 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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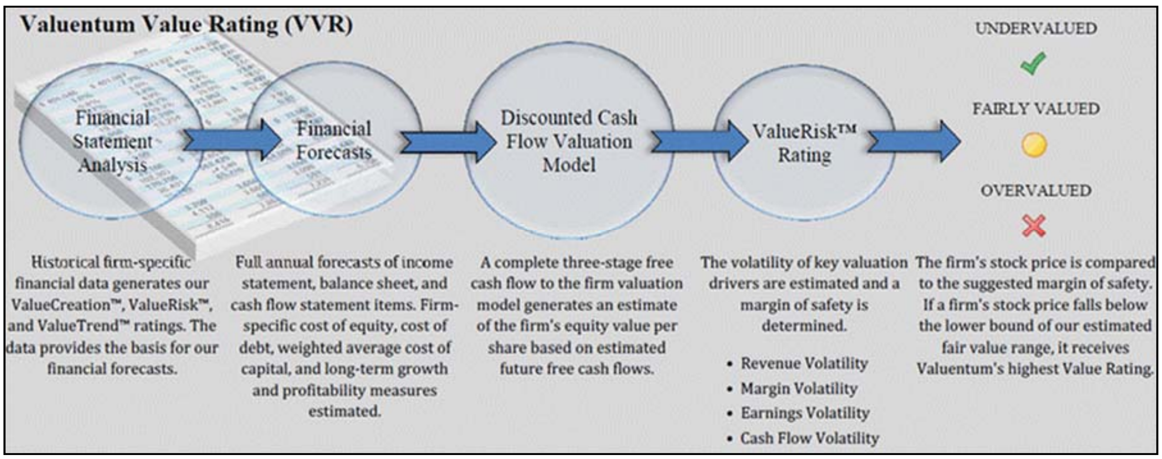
Our Methodology – The Valuentum Buying Index continued on next page

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

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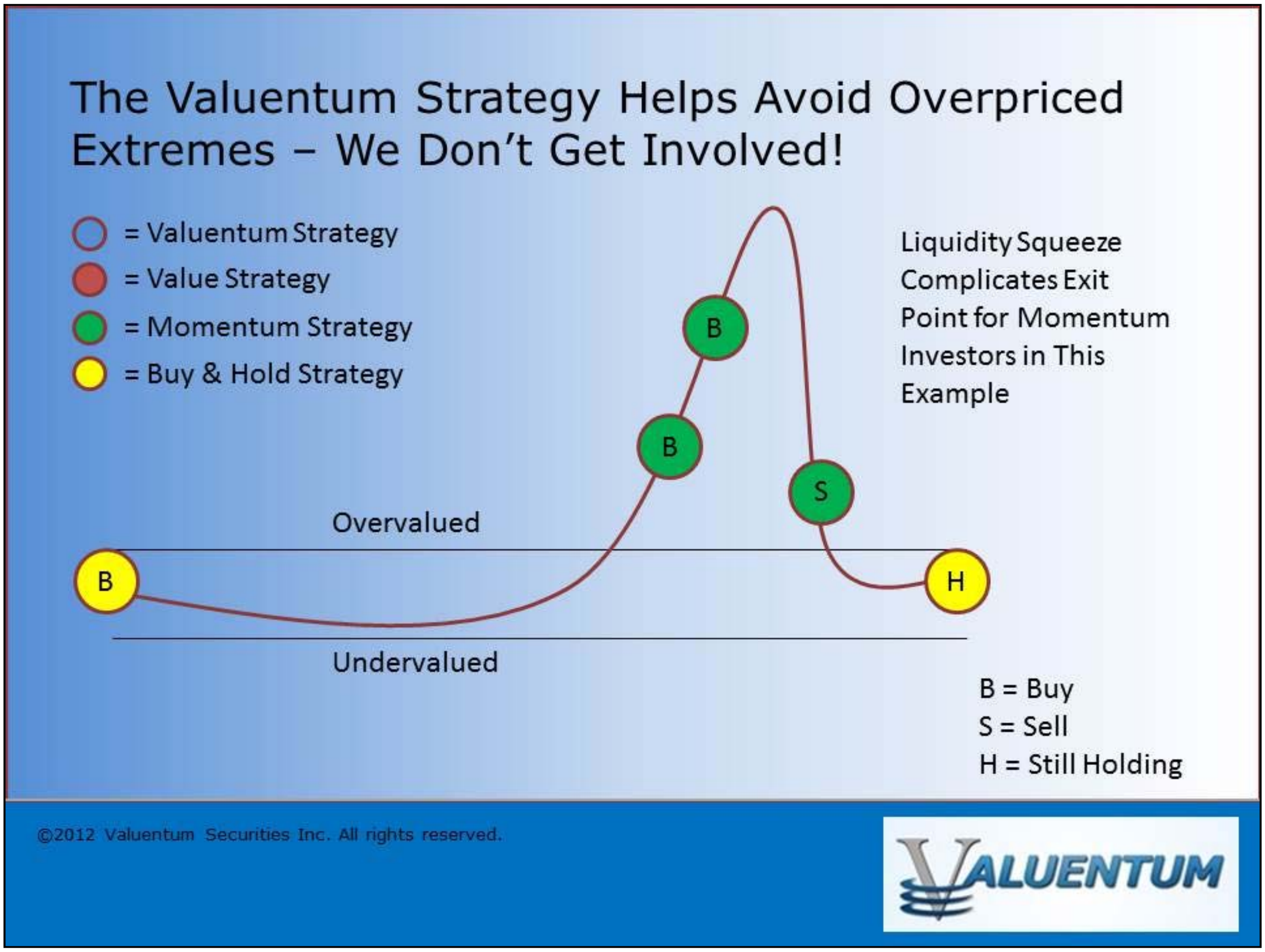

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II. The Valuentum Buying Index Incorporates A Forward-Looking Relative Value Assessment

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).

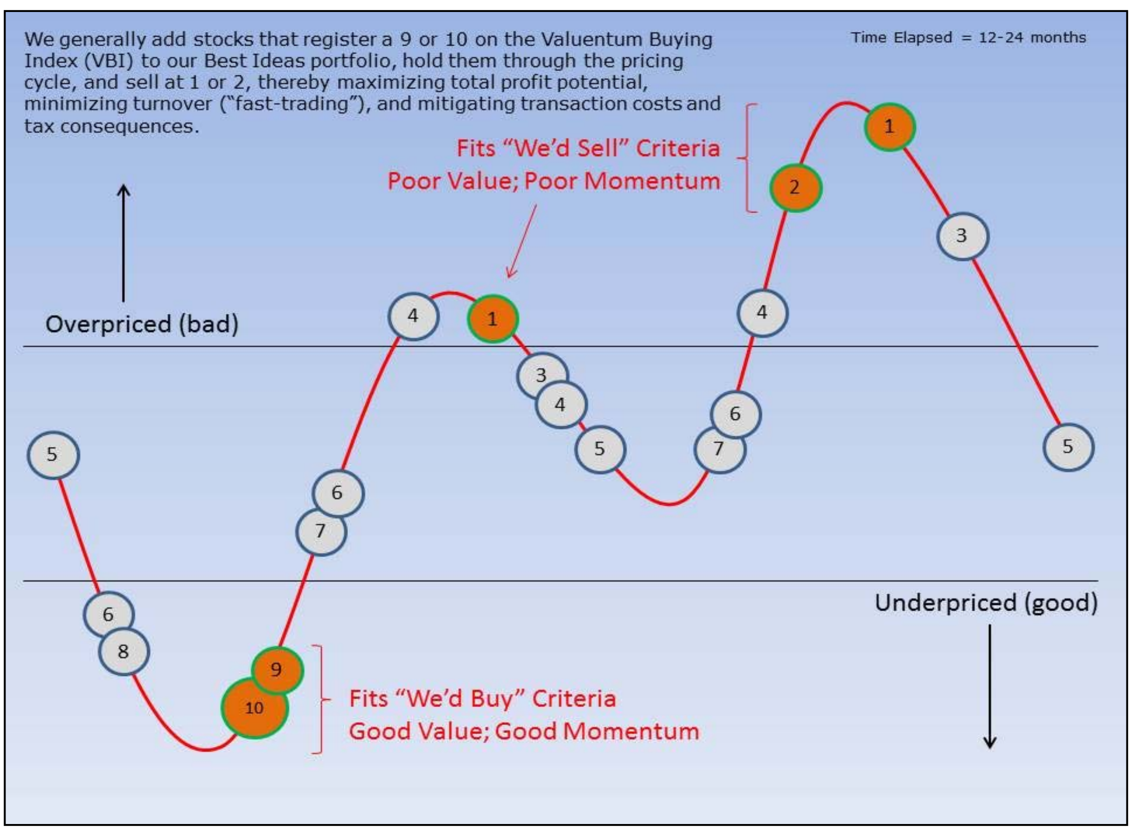
Rigorous valuation analysis and technical analysis are not mutually exclusive, and we believe both can be used together to bolster idea generation. An evaluation of a stock's moving averages, relative strength, upside-downside volume, and money flow index are but a few considerations we look at with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

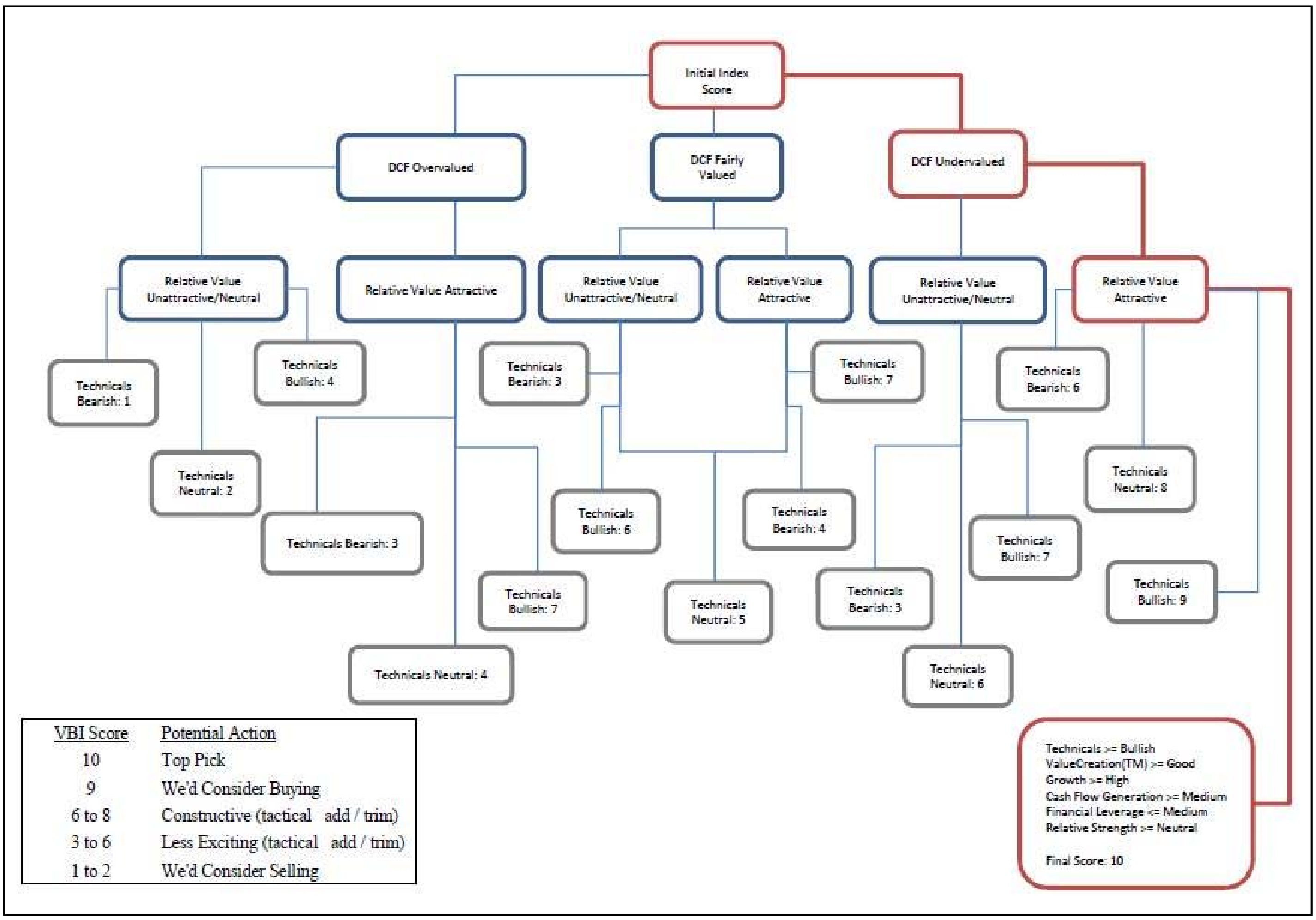


Illustration for educational purposes only.

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?

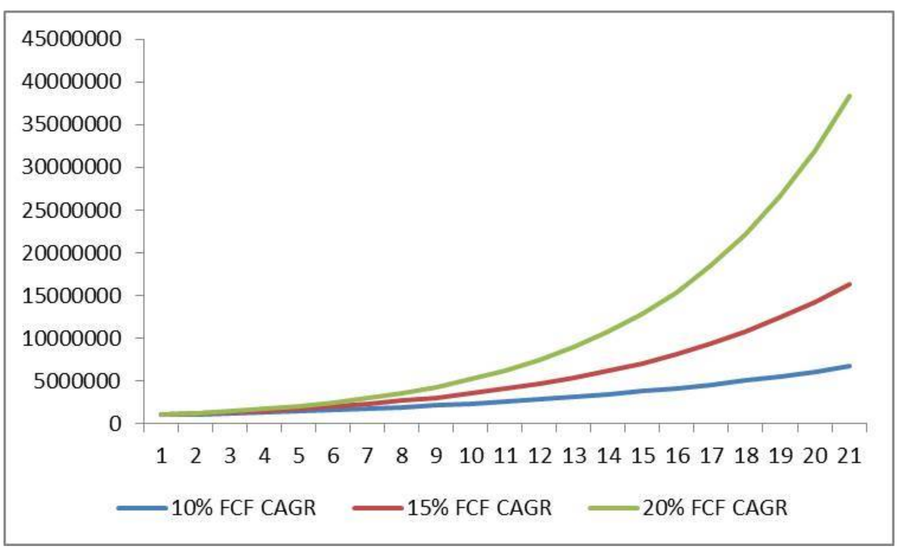
One of the most important concepts of the Valuentum methodology (and valuation in general) is the understanding that the value of a company is a range of probable valuation outcomes, not a single point estimate. Even well-seasoned stock analysts are guilty of saying that a company's shares are worth 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.

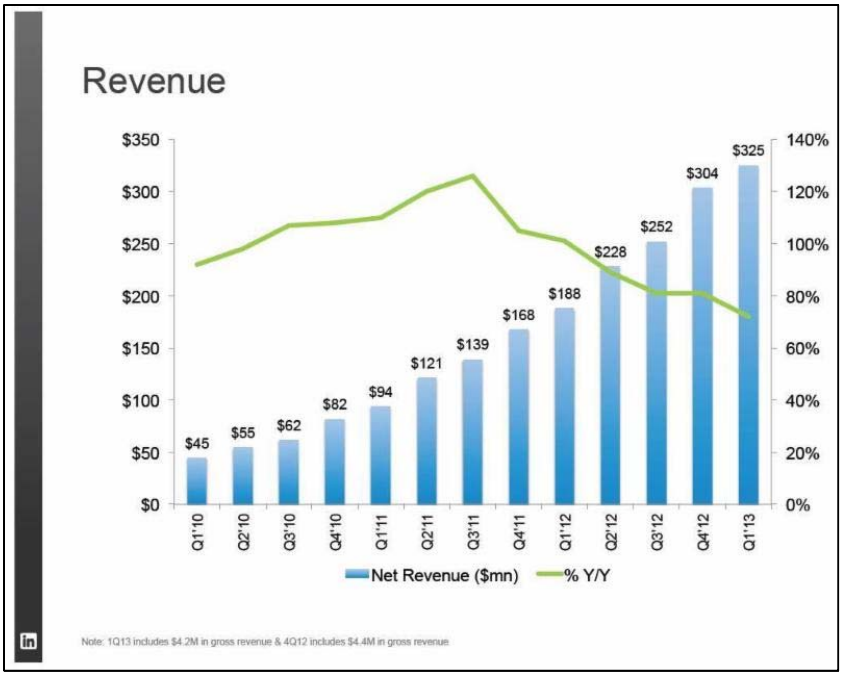

Image Source: LinkedIn

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 our case study, 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 our 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 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 data points measuring the outcome of the work we do on the website, rolled into an assessment: our best ideas for each respective strategy. 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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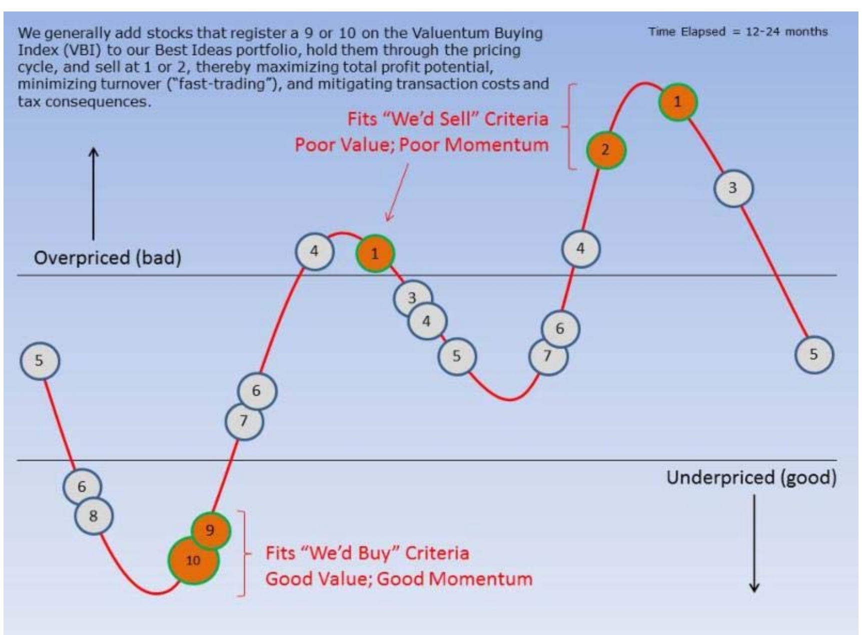
may be the secret to success in investing, a lot could have gone wrong with the temptation to do something each day. Obviously, we're very disciplined, but we also credit the portfolio outperformance to the VBI methodology itself. It is a very helpful tool.

** 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 (2012). 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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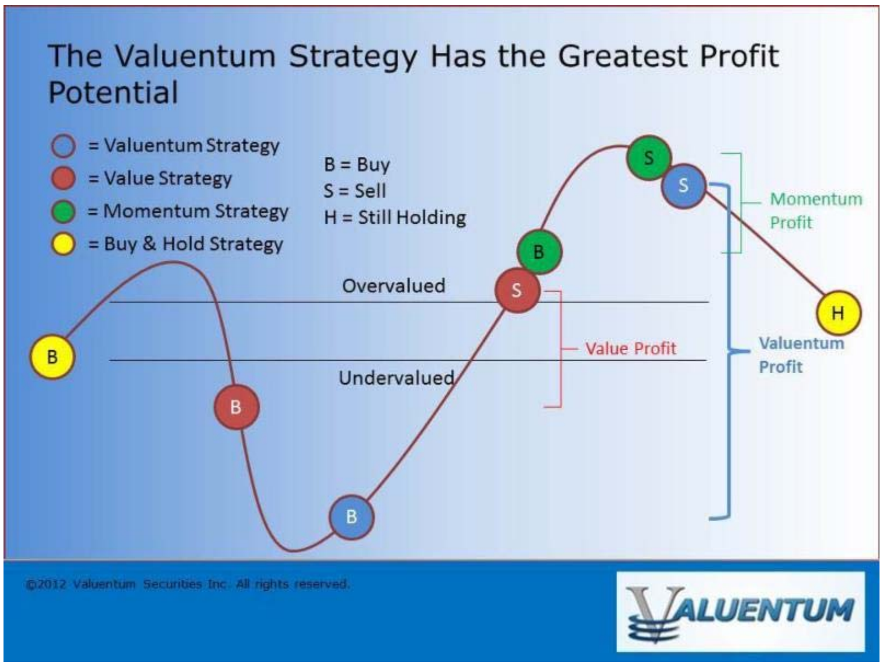
But why don't we churn our ideas by updating daily and trading a lot? Obviously, we don't think that's the secret to investment success. In quite the opposite approach, we strive to maximize profits on every idea that we pursue, with the understanding that momentum does exist and that prices over and 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 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. 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 12

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Valuentum's company-specific forecasts used in its discounted cash flow model are rules-based. These rules reflect the experience and opinions of Valuentum's analyst team. Historical data used in our valuation model is provided by Xignite and from other publicly available sources including annual and quarterly regulatory filings. Stock price and volume data is provided by Xignite. No warranty is made regarding the accuracy of any data or any opinions. Valuentum's valuation model is based on sound academic principles, and other forecasts in the model such as inflation and the equity risk premium are based on long-term averages. The Valuentum proprietary automated text-generation system creates text that will vary by company and may often change for the same company upon subsequent updates.

Valuentum uses its own proprietary stock investment style and industry classification systems. Peer companies are selected based on the opinions of the Valuentum analyst team. Research reports and data are updated periodically, though Valuentum assumes no obligation to update its reports, opinions, or data following publication in any form or format. Performance assessment of Valuentum metrics, including the Valuentum Buying Index, is ongoing, and we intend to update investors periodically, though Valuentum assumes no obligation to do so. Not all information is available on all companies. There may be a lag before reports and data are updated for stock splits and stock dividends.

The portfolio in the Valuentum Best Ideas Newsletter is hypothetical and does not represent real money. Past simulated performance, whether backtested or walk-forward or other, is not a guarantee of future results. Actual results may differ from simulated portfolio information being presented in this newsletter. For general information about Valuentum's products and services, please contact us at valuentum@valuentum.com or visit our website at www.valuentum.com.