OUR BEST IDEAS NEWSLETTER

Facebook (FB) Still a 10 on VBI!

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, BKNG, CMG, CSCO, DG, FB, GM, GILD, GOOG, XLV, INTC, JNJ, PYPL, SDY, UNP, XLE,VRNT, V

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Goal of the Best Ideas Newsletter

The goal of the Best Ideas Newsletter is to highlight ideas with strong capital appreciation potential and to update readers about new developments in the market. A simulated portfolio of capital appreciation ideas is presented on page 8 of each edition.

Inside This Issue

"For the team to achieve what it was able to do, despite a ~25% cash "position" in the simulated Best Ideas Newsletter portfolio, and in the context of the vast majority of active fund managers underperforming their respective benchmarks, is quite amazing."

– Brian Nelson, CFA

Visa!

By Brian Nelson, CFA

Image shown: The performance of Visa since it was added to the Best Ideas Newsletter portfolio.

The Valuentum team has put together an incredible track record during the past several years, and frankly, if you haven't already, you have to read through the analysis of the history of the simulated Best Ideas Newsletter portfolio. It goes into why we think the way we do and provides a variety of references to our processes and methodology.

The analysis can be downloaded at the following link (pdf):

https://www.valuentum.com/downloads/20180530/download

For the team to achieve what it was able to do, despite a ~25% cash "position" in the simulated Best Ideas Newsletter portfolio, and in the context of the vast majority of active fund managers underperforming their respective benchmarks, is quite amazing. What I wanted to introduce in this note, however, is the concept of prudence. It's something that we talk about frequently in passing, but I wanted to offer a couple examples. We sometimes make shifts in the portfolio that are independent of our views of the stock.

In the Dividend Growth Newsletter portfolio, for example, we steadily reduced the "weighting" in big-winner Microsoft (MSFT) over time (January 2015 & June 2016) from its original 8% "weighting" at inception of the newsletter portfolio at the beginning of 2012. Microsoft, itself, had remained in the Dividend Growth Newsletter portfolio as one of our favorite dividend growth ideas (and it does to this day), but as its equity price continued to advance, taking some exposure of this winner off the table can

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make sense. Had things, for example, not continued to work out for Microsoft, we would have given back a lot of "gains."

The example in the Best Ideas Newsletter portfolio is Visa (V). At the end of 2017, Visa was an 8%-9% "weighting" thanks to its fantastic performance in recent years. That's a heavy weighting! Generally speaking, we would grow very concerned as positions advance to the high-single digit level percentage range, and significantly so in the double-digit percentage range, due to growing concentration risk. A 10%+ weighting in a portfolio is a big weighting, in our view.

Though compounding is a fantastic dynamic (holding over time), the point is that over time, too, a constituent can sometimes become too large a portion of the portfolio, and even if we still like the company, sometimes prudence necessitates scaling back exposure, if only a little. For example, we reduced the "weighting" in Visa by 20% in August 2013, at a time when the company was already reflecting a 60% "gain." Had we not scaled back our exposure, it's likely Visa would have grown to an uncomfortably large percentage of the portfolio.

Hindsight will always be 20/20, and while simulated newsletter portfolio returns would have been even better had we stuck with the outsize positions of Microsoft or Visa in the Dividend Growth Newsletter portfolio and Best Ideas Newsletter portfolio, respectively, being prudent is often a quality that is measured most appropriately when broader markets are under pressure. I hope that you've been enjoying this publication all these years, and I hope you enjoy this edition of the Best Ideas Newsletter.

The Promise of CAR-T Therapy

The medical field, particularly the biotech industry, is quite innovative, and advances in medicine can help a specific target population with the ultimate gift--the gift of a better life. We're excited by the stunning advances in the CAR-T field for the treatment for various forms of cancer that have, in the past, come with an often-bleak prognosis. We expect a shift in the advances in immune-oncology as the CAR-T revolution is in its early stages.

By Alexander J. Poulos

Key Takeaways

CAR-T therapy holds the potential to revolutionize how hematological cancer is treated.

The biotech industry remains in the early stages of the revolution, but thus far the results have been promising.

We believe Gilead Sciences is best poised to exploit the promise of the therapy as its product continues to show the most durable response.

Until a competing therapy can enter the fray with a more efficacious product with a more benign side-effect profile, the market is Gilead's to lose, in our view.

Novartis, Celgene, and bluebird bio are other key players in the area of this budding new therapy.

What is CAR-T therapy?

CAR-T therapy is short for **C**himeric **A**ntigen **R**eceptor **T**-cell therapy a revolutionary treatment where an altered version of a patient's immune system is used to identify and kill cancer cells. The process begins with the collection of blood from the patient's arm, and the blood is filtered through an apheresis machine to separate out the white blood cells, which contain the T-cells—the key component of this therapy. The filtered blood is then returned to the patient with the white blood cells shipped off to a lab for modification. In the lab a gene is inserted into the T-cells called a Chimeric Antigen Receptor (CAR)—the Chimeric Antigen Receptor is the key player in this treatment as it allows the T-cell to bind to a certain protein found in the cancer cells. The modified T-cells are then grown in the lab with the end goal of re-infusion back into the patient.

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Challenges of the Therapy

The intricate process to harvest, modify and reintroduce the altered T-cells is a painstakingly, delicate process that requires significant technical expertise as the process is highly patient selective. As the current time, the therapy is tailored to the individual patient with the relative lack of automation, which adds to the cost and ultimate speed of which therapy can begin. We have seen estimates ranging from 17-28 days for a complete course of therapy, which limits the sheer number of patients that can receive therapy at once. Due to the requirement of modification in the lab of each patient's T-cells, highly trained individuals must complete the required step, which increases the overall cost of the therapy This can be problematic in the current time of highly-strained national healthcare budgets.

The greatest drawback to the therapy is the potential for Cytokine Release Syndrome (CRS), a release of cytokines from the host body in response to Car-T therapy. Cytokines are a form of immunity the body utilizes to fight off cells that the body recognizes as foreign. Granted the modified T-cells were once from the host, the additional of CAR may trigger an immune response. Signs of CRS include fever, sweat, chills similar to the symptoms seen in a patient who is fighting the flu. The drawback in the case of CAR-T therapy is that CRS has led to death for some of the patients involved in the clinical trials for this innovative treatment.

How Effective Is the Therapy?

The short answer to the question is revolutionary as witnessed by the overall response rates posted in clinical trials by the two products that have been granted marketing authority in the US and European Union. The companies that own the only two approved therapies on the market today are in our simulated newsletter portfolios with dividend growth stalwart Novartis (NVS) owning the rights to Kymriah and Best Ideas and Dividend Growth Newsletter portfolio idea Gilead Sciences (GILD) acquiring the rights to the nascent industry leader Yescarta via the Kite Pharma acquisition.

Both Kymriah and Yescarta gained approval for patients with relapsed or refractory (r/r) large B-cell lymphoma after two or more lines of systemic therapy including diffuse large B-cell lymphoma (DLBCL), a particularly bleak form of hematological cancer with a poor prognosis via conventional treatment. The median survival rate of this patient population is 4 months with a complete response to therapy seen in 8% and partial response in 18%. Yescarta posted an astonishing overall response rate in 83% of the patients including a complete response in 58% of the patients based on data from the long-term Zuma-1 follow up which consisted of a median follow-up at 15.1 months. The data presented by Yescarta is far and away superior, in our view, than conventional therapies that, even with a 13% chance of grade 3 or higher Cytokine Release Syndrome, the rewards far outweigh the risks of the therapy, in our view.

The results for Kymriah are a marked improvement overall conventional therapy, but pale in comparison to the stellar results posted by Yescarta. On the basis of the data presented by the Juliet trial, Kymriah posted an overall survival rate of 37% at six months which consisted of 30% complete response and 7% partial response. The incidence of grade 3 or higher CRS is 23%, leaving the product at a competitive disadvantage compared to Yescarta, which underscores our bullish stance on Gilead Sciences as the company remains at the forefront of CAR-T therapy. The potential patient population for this treatment is estimated to be 29,000 patients in second line and 19,000 in third line therapy according to Novartis (a very robust patient population).

New Competition

The third entrant into the budding field is Celgene (CELG) via the recent acquisition of Juno Therapeutics for its novel CAR-T platform. Liso-cel (JCAR017) is actively being developed for the treatment of Relapsed or Refractory B-cell lymphoma similar to Kymriah and Yescarta. The results posted are in-line with the key takeaway of the side-effect profile, especially for CRS, but it seems more benign than what we have witnessed in Yescarta.

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JCAR017 at the one-year mark showed 46 of the 102 test subjects revealing a response with 37 still showing a complete response. The incidence of grade 3 or higher cytokine release is 1%, which opens the product to lay a claim for a potential best-in-class safety profile. We view the results as excellent yet nowhere near as impressive as Yescarta, which in our view should dominate the field even with a higher incidence of CRS.

Our relative confidence in Yescarta revolves around the sheer cost and the "give me my best shot" concept. The sheer cost of the therapy will more-than-likely limit it to a once-a-lifetime event, hence the need for patients to choose what they believe will give them the best shot at survival. The 83% overall response rate for Yescarta will, in our view, likely cause the bulk of potential patients to choose this therapy as they may view it as their best shot at survival, even as they weigh the risk of CRS.

The most unique entrant into the field is bluebird bio (BLUE), with its anti-B-cell maturation antigen (BCMA) CAR-T cell therapy for the treatment of late-stage relapsed/refractory multiple myeloma an area of strength for its development partner Celgene. Thus far, the treatment has posted an overall response in 95.5% of the patient class at the >150 x 106 dose, but we must caution the sample size of 22 patients for this cohort is very small. 50% of the patient class displayed a complete response with a median follow-up at the 194-day mark. The incidence of CRS is 39% with no grade 3 or higher reported at the >150 x 106 whichbodes well thus far for tolerability. The trial results are phase one, but we view them as encouraging and worth Celgene and its partner bluebird bio's capital to continue further development of this product.

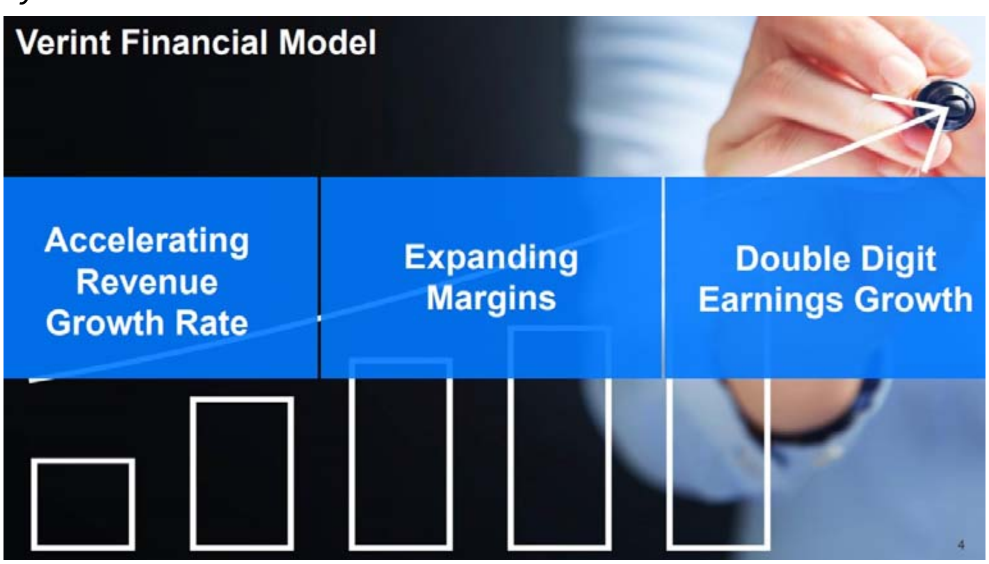
Conclusion

The CAR-T revolution remains in its infancy with many biotech/pharma heavyweights jockeying for dominance. If we had to handicap the race in its current form, we feel Gilead Sciences is in the most enviable position, but the rate of CRS remains Yescarta' Achilles heel. We will continue to follow the data closely as we feel the therapy has the potential to revolutionize the way we treat hematological cancers.

Independent Healthcare Contributor Alexander Poulos is long Gilead Sciences. Some of the companies written about in this article may be included in Valuentum's simulated newsletter portfolios. Contact Valuentum for more information about its editorial policies.

Verint Trading Near 52-Week Highs

By Kris Rosemann



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Simulated Best Ideas Newsletter portfolio idea Verint turned in a solid fiscal first quarter report June 7 as ongoing demand strength drove its top line higher. The company's transition to a more software-focused business model is expected to continue expanding margins. Verint is a unique play on cybersecurity.

Simulated Best Ideas Newsletter portfolio idea Verint (VRNT) continues to ride a wave of strong demand for its offerings in both its 'Customer Engagement' and 'Cyber Intelligence' segments to a growing top line, expanding margins, and solid cash flow generation. In its fiscal first quarter report, results released June 7, the company reported non-GAAP revenue growth of 10% from the year-ago period, driven by 8% growth in 'Customer Engagement' (65% of revenue in the quarter) and 13% growth in 'Cyber Intelligence' (35% of revenue).

Management notes three key trends in its 'Customer Engagement' segment that are keeping demand high and could accelerate growth over time. The first is the trend of customer engagement becoming an enterprise-wide initiative for companies and the desire for simplification of such initiatives. The second is enterprise demand for modernization and migration to the cloud while preserving past investments. Verint believes it is effectively differentiated in this space thanks to the flexibility it offers via its public, private, and hybrid cloud offerings, which allow companies to modernize at their own pace. The third key trend is organizations using automation to elevate the customer experience while simultaneously reducing costs.

The strong growth Verint reported in its 'Cyber Intelligence' segment reflects ongoing demand for its security and data mining software, and an uptick in large deals gives credence to its ability to anticipate market trends and bring innovative offering for the evolving challenges faced today. **Three market trends are in place that have the potential to accelerate the segment's revenue growth moving forward, the first of which is the increasing complexity of security threats.** The second trend is a shortage of data scientists and cyber analysts as organizations seek advanced automation to replace functions previously done by humans. Finally, security organizations are looking to predictive intelligence, in which Verint has a unique leg up thanks to its security and data mining software deployments already giving it customer relationships in more than 100 countries and providing it with insights into current and future challenges.

Verint's non-GAAP diluted earnings per share expanded to $0.53 in its fiscal first quarter from $0.49 in the year-ago period. The company's product, services, and revenue mix can cause margin fluctuations on a quarterly basis, but it expects ongoing margin expansion as a result of its transition to a more software-focused business model, which should also drive recurring revenue higher as a percentage of total revenue, and efficiencies of scale. Cash flow from operations in the first quarter was roughly flat on a year-over-year basis at ~$60 million, and free cash flow retreated by ~2% to $51 million as a result of higher capital spending in the quarter.

Net debt (including unamortized debt discounts and issuance costs and excluding long-term restricted cash, cash equivalents, and time deposits) was ~$398 million at the end of the quarter, down from $445 million three months earlier. Management classified the recent report from the Wall Street Journal that it is in talks to buy Israeli cybersecurity firm NSO Group as "rumors," but it did note that it would be willing to temporarily lever up for the right acquisition as its financial leverage is currently less than 2x EBITDA.

Verint reiterated its guidance for the fiscal year ending January 2019, which includes mid-single digit revenue growth in its 'Customer Engagement' segment and 10% revenue growth in its 'Cyber Intelligence' segment. Total revenue is expected to be $1.23 billion, or ~7% year-over-year growth, and non-GAAP earnings per share are expected to be ~$3.09, compared to $2.81 in the previous year. We like Verint's position in the simulated Best Ideas Newsletter portfolio as a unique idea on cybersecurity.

PayPal Grows Stronger

PayPal scooped up assets that will help it better compete against Square, and we think both entities have a bright future regardless of the increased competition.

By Brian Nelson, CFA

It's no secret that PayPal (PYPL) generates a considerable amount of free cash flow and boasts a very strong net cash position that allows it to scoop up assets that it deems worthy of the long-term picture. Many have been concerned about PayPal's expected loss of its contract with eBay (EBAY) in 2023, and it was quite the blow, but the entire relationship merely amounts to a few months of organic growth at the payment-processing giant.

We also view Bitcoin and other cryptocurrencies as more of an opportunity than a threat for PayPal, as most banking transactions remain of the cash or check variety, a difficult-to-believe reality in the age of digital money transfer. Amazon (AMZN) is reported to be interested in the digital payments space, and Facebook (FB) is reported to be working to develop its own cryptocurrency, perhaps paving the way for it to become an e-commerce giant, but we continue to believe the payment-processing industry is large enough for a great many players.

In addition to the operational funding mechanism via considerable free cash flow generation and one of the best balance sheets around, PayPal benefits from something called the "network effect." As with our favorite credit-card network providers, Visa (V) and MasterCard (MA), as more and more consumers use its service, more and more merchants accept the platform and so on. The credit card networks have benefited from this dynamic for as long as one can remember, but eBay may have brought the concept front and center during the dot-com bubble era. Facebook benefits from a network effect, too.

On May 18, PayPal announced that it would buy Sweden's iZettle, a provider of credit card readers to small businesses, much like Square, in an all-cash deal of $2.2 billion. The deal will open up the huge European and Latin American markets for PayPal, while augmenting its existing technology and bring on board a talented team that only further accelerates the curve of payment innovation. The price tag for the transaction is considerably higher than iZettle's expected valuation at its proposed IPO this year and rather hefty, too, given that iZettle is not yet profitable. PayPal, however, held ~$7.5 billion in cash and cash equivalents at the end of 2017 against just $1 billion in notes payable on the books, so it can absorb iZettle without skipping a beat.

The simulated Best Ideas Newsletter portfolio inherited the position in PayPal as a result of the split with eBay, and shares of PayPal have surged since. Now trading at north of $80, it has been a fantastic ride for those paying close attention to our favorite ideas in the simulated Best Ideas Newsletter portfolio. As is customary, we wait until a stock is both overpriced by our discounted cash flow process and its technical/momentum indicators weakening before we'd consider removing it. PayPal remains a key idea in the newsletter portfolio.

Private Equity Likely Interested in GameStop As Netflix Shocks Gaming Industry

Netflix may have taken the initial steps to enter the video-gaming market. Even as the digital streaming of games may have already signaled the death knell of GameStop's lucrative physical used-game business, that Netflix may be moving into video games may further truncate not only GameStop's longevity, but also have ramifications across the entire video-gaming landscape. Private equity may be interested in GameStop, nonetheless.

By Brian Nelson, CFA

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The video-gaming complex was upended June 13 when Netflix (NFLX) announced that it would be producing "an interactive Minecraft series for kids and licensing Stranger Things for a video game." Netflix said it doesn't "have any plans to get into gaming," but we think it only makes sense and is likely inevitable. Outerwall, which owns the Redbox movie rental kiosks, has been facilitating the rental of video games from its locations for as long as we can remember, and this has been a huge untapped source of revenue and customer retention for Netflix. Even if gaming may not trigger a price increase at the movie-streaming giant, it may keep customers on its platform longer, especially given the rise in gaming interest of late.

We think the end game is becoming clearer for GameStop (GME). Though the company generates considerable free cash flow, on average $400 million, during the past three fiscal years, and has a relatively net-neutral balance sheet at fiscal-year ends, it continues to face an uphill battle, as total global sales fell 5.5% during its fiscal first quarter, almost wholly attributable to a same-store sales decline, though it did face a difficult comp given Nintendo's (NTDOY, NTDOF) launch of the Switch in the prior-year quarter. GameStop's adjusted earnings per diluted share came in at $0.38 versus adjusted earnings per diluted share of $0.63 in the prior-year period, and we would expect year-over-year weakness to persist, despite what is traditionally a back-end loaded fiscal year. We think GameStop may be of interest to private equity as a wind-down story, but its technicals are atrocious for it to qualify as one of our best ideas.

The rest of the gaming landscape hiccupped after the Netflix announcement, with Activision (ATVI), Electronic Arts (EA) and Take Two (TTWO) experiencing volatile, but generally positive trading. The video gaming industry is experiencing tremendously high demand, and reports of professional gamers making $500,000 a month may be only attracting more and more gamers. We think if Netflix does decide to move more heavily into video gaming, it may likely have to license games from the publishers, a short-term win for gaming-makers. However, as with what happened with Netflix and movies, we can't rule out Netflix working with publishers to eventually make its own video games. We'd view this as a long-term negative for the videogame publishers, but certainly not something that will impact performance in the very near term.

We continue to watch Netflix's equity price move higher, and while we raised its fair value estimate more recently, we still believe shares are built more on castles-in-the-air than on a firm foundation. The company did show in its most recently-reported quarter that its business does have earnings leverage, but the degree of which remains why we have such a large fair value estimate range. The hit-or-miss nature of video-game development, in general, makes the video game publishers less attractive as long-term investments, in our view, if only relative to our existing ideas in the simulated Best Ideas Newsletter portfolio. The gaming end market remains incredibly healthy, however, and it will likely only get stronger as the coming generation continues to embrace gaming technology.

We think GameStop's shares are undervalued, but our fair value estimate may likely approximate what private equity may be valuing the equity at, rather than what the marketplace is willing to pay for shares. If we assume GameStop doesn't lever up and generates half of its annual run-rate free cash flow into perpetuity ($200 million), approximating a gradual decline into obscurity, a discount rate of 8%-10% implies an equity market value of $2-$2.5 billion, about in-line with our in-depth fair value estimate calculation, which values shares north of $20 each. If private equity steps in, GameStop could be a winner from current levels. If not, its equity price could languish for years.

Valuentum's Best Ideas Portfolio

By Valuentum Analysts

NEW *Valuentum released a study on its Best Ideas Newsletter portfolio! Please download the paper at the following link:*

https://www.valuentum.com/downloads/20180530/download

Note: Alphabet's "weighting" now reflects a consolidation of Class A and Class C shares held previously in the simulated newsletter portfolio.

Valuentum's BEST IDEAS -- as of June 15, 2018

Portfolio Holdings	Symbol	Div Yield %	Fair Value	Economic Castle	VBI Rating	P/FV	Last Close	% of Portfolio
Berkshire Hathaway	BRK-B	0.00%	$211.00	NA	5	0.91	191.76	5.5%-10%
Facebook	FB	0.00%	$250.00	Very Attractive	10	0.78	195.85	5.5%-10%
Alphabet - Class C	GOOG	0.00%	$1322.00	Very Attractive	7	0.87	1152.26	5.5%-10%
Visa	V	0.64%	$130.00	Attractive	6	1.04	135.10	5.5%-10%
Apple Corp.	AAPL	1.56%	$220.00	Highest Rated	6	0.86	188.84	4%-5.5%
SPDR S&P Dividend ETF	SDY	2.34%	NA	NA	UR	NMF	93.52	4%-5.5%
Energy Select SPDR	XLE	2.96%	NA	NA	UR	NMF	74.13	4%-5.5%
Health Care ETF	XLV	1.51%	NA	NA	UR	NMF	85.48	4%-5.5%
Cisco	CSCO	3.05%	$48.00	Very Attractive	3	0.92	44.25	2.5%-4%
Intel	INTC	2.19%	$56.00	Attractive	7	0.98	55.11	2.5%-4%
Johnson & Johnson	JNJ	2.57%	$133.00	Attractive	3	0.92	122.61	2.5%-4%
Altria Group	MO	4.84%	$67.00	Very Attractive	3	0.86	57.79	2.5%-4%
Booking Holdings	BKNG	0.00%	$2104.00	Highest Rated	6	1.02	2141.45	1.5%-2.5%
Chipotle	CMG	0.00%	$453.00	Very Attractive	6	1.02	462.01	1.5%-2.5%
Dollar General	DG	1.24%	$98.00	Attractive	4	0.99	97.33	1.5%-2.5%
Gilead Sciences	GILD	3.17%	$98.00	Very Attractive	3	0.72	70.23	1.5%-2.5%
General Motors	GM	3.45%	$61.00	Attractive	7	0.72	43.91	1.5%-2.5%
PayPal	PYPL	0.00%	$81.00	Attractive	6	1.05	85.31	1.5%-2.5%
Verint Systems	VRNT	0.00%	$54.00	Very Attractive	7	0.85	46.15	1.5%-2.5%
Cash consideration	-	-	-	-	-	-	-	5%-30%

UR = Under Review
This portfolio is not a real money portfolio. Data as of June 15, 2018.
We have consolidated our simulated position in Alphabet to the highest weighting to reflect our confidence in the idea.

Goal: The simulated Best Ideas Newsletter portfolio seeks to find stocks that have both good value and good momentum characteristics and typically includes in the simulated portfolio each idea from a Valuentum Buying Index rating of a 9 or 10 (consider buying) to a rating of a 1 or 2 (consider selling). Just like a value manager may not include every single undervalued company in the market in his/her portfolio, not all highly-rated companies on the Valuentum Buying Index are included in the portfolio.

We may tactically add to or trim existing positions in the portfolio on the basis of sector or broader market considerations, but we seek to capture a stock's entire pricing cycle (from being underpriced with strong momentum to being overpriced with poor momentum). The Best Ideas Newsletter portfolio puts the Valuentum Buying Index into practice.

Every person has different goals and different risk tolerances, so where before in the simulated newsletter portfolios, we would outline the specific percentage weighting, we think providing ranges make much more sense. For example, depending on someone's risk tolerances, a larger cash position in an overheated market may be prudent. On the other hand, the longer one's time horizon, perhaps a smaller cash position may make more sense. This isn't for us to decide, and frankly, we want to be relevant for as many as we can in the investment community because we think we have something for everyone!

Ideas may not add up to 100% on either the low % or high % due to rounding and/or other combinations / permutations.

Solar Not So Hot

Though First Solar stands alone as one of the stronger players in the solar space, we think the industry backdrop is among the weakest in our coverage universe. We're huge fans of clean renewable energy but separating what we want to be a good industry like solar from an industry that actually has strong structural characteristics is a key component of being a good investor. Oftentimes, it is better to own an average company in a great industry than a good company in one of the worst industries out there.

By Brian Nelson, CFA

Sometimes it is too easy to invest with your heart and overlook opportunities across "sin" stocks. For example, you may dislike tobacco, and you have every right to, but tobacco stocks such as Altria (MO) have been among the best-performing investments over the past many years. You may abhor gambling, but Churchill Downs' (CHDN) stock has really caught a huge bid on new regulations to legalize sports betting. Alcohol may literally not be your "cup of tea," but a company such as Constellation Brands (STZ) has had an impressive stock-price run since the doldrums of the last recession.

Likewise, and to the point of this article, it's equally important to separate what you want to believe is an excellent ("feel good") product and what you may think is a good investment opportunity, as sometimes these two things can be very different. The specific topic in mind is solar energy. Solar energy remains one of the fastest-growing forms of renewable energy, and the environmental benefits have been well documented. The industry has even worked aggressively to lower the cost of producing solar electricity, and we can only expect further improvements as technology continues to advance. However, it's not that we don't like solar and renewable, clean energy, it's just that the industry backdrop is not necessarily conducive to companies being good investments:

> The solar industry continues to be characterized by intense pricing competition, both at the module and system levels. In particular, module average selling prices in the United States and several other key markets have experienced an accelerated decline in recent years, and module average selling prices are expected to continue to decline globally to some degree in the future. In the aggregate, we believe manufacturers of solar cells and modules have significant installed production capacity, relative to global demand, and the ability for additional capacity expansion. We believe the solar industry may from time to time experience periods of structural imbalance between supply and demand (i.e., where production capacity exceeds global demand), and that such periods will put pressure on pricing. Additionally, intense competition at the system level may result in an environment in which pricing falls rapidly, thereby further increasing demand for solar energy solutions but constraining the ability for project developers, EPC companies, and vertically-integrated solar companies…to sustain meaningful and consistent profitability (source: First Solar 2017 10-K).

We know such an excerpt from First Solar's (FSLR) 2017 10-K doesn't apply to all companies in the solar industry, but the backdrop is nonetheless poor, if not as bad as First Solar makes it out to be. It is often the case that a large percentage of company economic returns are determined by the industry in which a company operates, and the solar industry is one difficult industry to carve out a sustainable competitive advantage, let alone sustainable economic profits. First Solar is our favorite idea in the solar space, if we ever had to pick one, but that doesn't mean that we like it better than Apple (AAPL), Facebook (FB), or Visa (V), for example. Think of First Solar as the good company in one of the worst industries possible. Oftentimes, it is better to own an average company in a great industry than a good company in one of the worst industries out there.

On June 4, the *South China Morning Post* reported that China (FXI, MCHI) is taking measures to "rein in the expansion of the industry, by suspending the construction of new farms and cutting subsidiaries." We think many publicly-traded solar entities were caught by surprise by the announcement, as shares of many sold off aggressively following the news. It looks as though China isn't standing behind the solar

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industry as much as many had hoped, and it's looking more and more likely that original global solar installation estimates are likely too high and have to come down. We don't think this is the death knell for many smaller participants in the solar complex, but we do think it may make it harder for them to raise much-needed financing. We're going to continue to stay away from investing in solar, no matter how much we like clean, renewable energy.

Fishing Trends Benefiting Many Sporting Goods Retailers

Johnson Outdoors is benefiting greatly from fishing-related sales, and such a tailwind may be helping other sporting goods retailers in the group. New store openings continue to drive Dick's Sporting Goods' top-line higher, but the company's materially increased profit guidance for fiscal 2018 stole the show in its fiscal first quarter report.

By Kris Rosemann

The sporting goods industry seems to have found the path to resiliency, despite continued political debate around gun control in the wake of school and event shootings, and some vendors such as Dick's Sporting Goods (DKS) even going as far as destroying the assault weapons once for sale on their shelves. We'll talk more about Dick's Sporting Goods' strength in this note, which has positive implications at Hibbett (HIBB) and Big Five Sporting Goods (BGFV), but the company's resilience might also be a good sign for some of the athletic-oriented sporting apparel providers, particularly Under Armour (UA, UAA), which by our channel checks has prominent placement in many Dick's Sporting Goods' stores.

Dick's Sporting Goods released its fiscal 2018 first-quarter results in late May, and the market absolutely loved them. During the quarter, net sales advanced 4.6% from the year-ago period thanks to new store openings, but same store sales still fell 2.5% when adjusted for the calendar shift due to the 53rd week in 2017. A continued deceleration in hunt and electronics sales and colder spring weather were key factors in the same-store sales weakness, but digital sales leapt by 24% and accounted for 11% of revenue in the quarter compared to 9% in the first quarter of fiscal 2017.

We think Dick's Sporting Goods benefited from strong fishing-related demand. Earlier in May, Johnson Outdoors (JOUT) reported a double-digit increase in its sales and earnings during its second quarter of fiscal 2018 (ends March), and the company pointed to fishing as its biggest and most profitable business (its fishing revenue was up 19% in the period). Johnson Outdoors benefits from the well-recognized Minn Kota and Humminbird brands with respect to fishing sales, but Dick's Sporting Goods also generates a meaningful percentage of business from this end market.

During the quarterly release, Dick's Sporting Goods reported that its net income per diluted share advanced to $0.59 in the quarter from $0.52 in the comparable period of fiscal 2017 thanks in part to a lower tax bill. Management was quick to point to execution against its merchandising strategy as a driver of higher merchandise margins. Fewer promotions and cleaner inventory were the result of product newness, private brand strength, and a more refined assortment, and the company expects these factors to persist as it continues to optimize its assortments.

Though things are looking better for Dicks Sporting Goods, its debt load has climbed in recent quarters, and net debt sat at just over $239 million at the end of the first quarter of fiscal 2018 compared to net cash of ~$11 million at the end of fiscal 2017 and net cash of ~$36 million a year earlier. Free cash flow on an annual basis (averaging ~$300 million in fiscal 2015-2017) has been more than sufficient in covering annual cash dividends paid ($73 million in fiscal 2017) in recent years. Shares yield nearly 2.5% as of this writing, and its Dividend Cushion ratio comes in at 2.5.

Dick's Sporting Goods' management took the opportunity to raise its bottom-line guidance following its solid fiscal first quarter and now expects earnings per diluted share to be in a range of $2.92-$3.12 in fiscal 2018 compared to previous guidance of $2.80-$3.00 and fiscal 2017 results of $3.01. Same store sales growth is expected to be flat to a low single-digit decline from fiscal 2017 levels on a 52-week to

*Fishing Trends…*continued on next page

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52-week comparative basis, but new store opening should help buoy the overall top line. Free cash flow should receive a boost from capital spending guidance of $280 million compared to $474 million in fiscal 2017.

We've raised our fair value estimate for Dick's Sporting Goods to $39 per share after rolling our valuation model forward to account for cash earned, factoring in management's new guidance, and assuming better margin performance thanks to recent improvements in promotional activity. We're generally not looking to add exposure to the big box retailer, or a sporting goods provider, in general, as the broader retail environment remains competitive despite recent strength in consumer spending as evidenced by the company's same store sales guidance for fiscal 2018. It doesn't mean that we don't like Dick's Sporting Goods or others in the group. It just means we don't like them more than Apple (AAPL), Facebook (FB) or Visa (V), as examples.

Johnson & Johnson's Litigation Risk Manageable

Let's talk about how to think about the impact of one-time events on intrinsic value estimates. The magnitude of damages against J&J with respect to its talcum-powder products could be large, but we think the market has slowly factored in the risk of legal liabilities. Once J&J puts these troubles behind it, we think the market may once again warm up to the equity. Shares are trading at only a modest discount to our intrinsic value estimate, however.

By Brian Nelson, CFA

A member of ours passed along a number of articles discussing litigation risk at Johnson & Johnson (JNJ) with respect to the company's talcum powder products, primarily JOHNSON'S Baby Powder. It's always very sad to hear of cases of cancer caused by anything, and it would be premature for us to gauge with certainty the magnitude of potential legal liabilities that J&J may encounter. To put it bluntly, it's unknowable at this time. According to Mesothelioma.com, there are ~6,600 talc-related claims against the pharma and consumer-products giant (~6,610 according to J&J's latest 10-K).

Legal liabilities are a big risk for any company, big or small, and J&J is no exception. Johnson & Johnson maintains that its talcum powder products have been asbestos-free for decades, and while talcum powder products that contain asbestos are believed to be carcinogenic by the International Agency for Research on Cancer (IARC), it's unclear whether inhaled talc (not containing asbestos) could lead to lung cancer, or if talc-based baby powder (not containing asbestos) for genital use is carcinogenic. The American Cancer Society may say it best: "The evidence about asbestos-free talc, which is still widely used, is less clear."

Whether J&J's talcum-powder products contained asbestos and whether talc not containing asbestos causes cancer are two big questions on the minds of Johnson & Johnson investors. Though it's nearly impossible to answer these questions, and if both are yes, how much J&J would be at fault and the magnitude of damages, we can probably attach a contingent liability figure to it, even if it may be nothing more than an educated guess. Complicating matters is that the magnitude of damages per case have been all over the place--a couple million in some cases, for example, and as much as $417 million in another case in August 2017, a verdict that was subsequently tossed out. J&J is vigorously defending itself against all claims, winning in some trials and getting other verdicts thrown out or reduced, further complicating the analysis.

We simply cannot handicap the outcome of thousands of jury trials, but we think if J&J is found liable for damages, it's likely it may amount to a few million dollars in each case, on average. The range of outcomes, however, is still rather large. In a verdict in April and another in May, damages were pegged at $37 million and ~$22 million, respectively. Just for perspective, and just to give an idea of how to think

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about one-time legal settlements in the context of equity valuation, let's throw out a few numbers. If we assume J&J loses half of its cases, but it is able to reduce the verdicts for the cases it loses to an average ~$5 million settlement, J&J could be on the hook for $16.5 billion (3,300 cases x $5 million). If we assume J&J loses all its outstanding cases at ~$10 million per settlement, on average, the company could be on the hook for $66 billion (6,600 cases x $10 million).

J&J's market capitalization is ~$330 billion at the time of this writing, so we're talking about a 5% baseline one-time impact to equity value under the first scenario and a 20% impact in the more-punitive latter scenario. It's probably most likely that any legal fees end up somewhere between these two numbers ($16.5-$60 billion), but again, the answer is unknowable at this time, and only presented if we had to peg an estimate. J&J's share price has fallen 15%-20% since the peak in early January this year, and while broader market concerns aided in the weakness, to a large degree, we think risks related to talcum powder products are already largely factored in, under the two reasonable base-case scenarios we've outlined.

It's important to differentiate one-time legal exposure such as talcum product liability from events that permanently increase continuing operating expenses, the latter having cascading implications on the company's value into perpetuity. Said another way, one-time impacts are generally one-for-one reductions to the company's equity value and are different than increased operating expenses, which can have a greater impact by reducing forward-looking free cash flows for years and years into the future. It's certainly not a good situation for J&J to be in, but its legal exposure to claims regarding its talcum powder products, including potential securities class action lawsuits, appear to be manageable.

RE: Energy Transfer Partners: Why You Shouldn't Worry, DEC 19, 2015

By Valuentum Analysts

Image shown: The performance of Energy Transfer Partners (ETP) since we warned about the MLP space in mid-2015.

*RE: Energy Transfer…*continued on next page

*RE: Energy Transfer…*from previous page

Now that simplification actions are on the rise in the MLP space, "Master Limited Partnership Simplications on the Rise," all but proving our thesis on the group, we thought it important to follow up on a December 2015 article that another firm wrote, "Energy Transfer Partners: Why You Shouldn't Worry."

For some reason, the article felt it appropriate to say that Valuentum is "unregistered." We wanted to clear this up. Valuentum is a financial publisher, much like the *Wall Street Journal* or the *Financial Times*, and publishers are exempt from registering.

Second, the article felt the need to put the word "independent" into quotes. We're not a money manager, or a broker, or a financial advisor, nor are we selling any securities, or soliciting the buying and selling of any securities. We think our thesis on the MLPs should have made our independence clear.

Finally, we thought it rather demeaning to put "analysts" into quotes, too. For starters, President of Investment Research Brian Nelson holds the Chartered Financial Analyst (CFA) designation, and we include relevant authors on our work on our website.

We'll never truly know the damage that has been caused by articles written in this spirit across the web, some articles we may not even know about. We thought it appropriate to clarify things in this response, and we're going to continue to take the high road with everything we do.

We hope you appreciate that and find tremendous value in the independent insight that our team of analysts provide.

Thank you!

Sports Betting Legalized; Churchill Downs Has Leg Up on Rivals

In a landmark decision, the US Supreme Court ruled that states could legalize sports betting. We expect this to be a positive catalyst for several gambling-related equities, and many are moving fast to capitalize on the development. We're taking a long-term view on potential ramifications and are not jumping head-first into any potential opportunities…yet.

By Brian Nelson, CFA

On May 14, 2018, in a 6-to-3 ruling, the Supreme Court of the United States ruled in *Murphy v. National Collegiate Athletic Association* that states could legalize sports gambling. The decision overturns the Professional and Amateur Sports Protection Act, a previous 1992 decision. The implications on a state by state basis have yet to play out, but we'd expect many states, including New Jersey, West Virginia, Delaware and Mississippi, to put into place measures to give the thumbs up on sports betting, as it surely will be a stimulant to economic growth and, of course, tax revenue for states. According to the New York Times, the black market for illegal sports wages is estimated at $150 billion, offering a huge market for existing private and publicly-traded gambling enterprises.

We'll withhold our views on what such a development means for society, but for those entities tied to the sports industry, including venues like Madison Square Garden (MSG), the development is a net positive. The ruling may impact the Vegas market negatively, as gamblers will no longer have to travel to the desert to place a wager on their favorite sports event, but we think most share will be taken from the black market. Furthermore, many are saying that fans will become more intrigued by sporting events, as once they're able to bet freely, they'll have "skin in the game" and be more attentive to the action. The ruling could even spur increased viewership at sports-heavy television networks such as Disney's (DIS) ESPN, for example. There may probably be a very large overlap between sports fans and

*Sports Betting…*continued on next page

*Sports Betting…*from previous page

those that gamble on the game already, but the impact of the ruling seems quite positive. The market for mobile sports betting may very well explode in coming years.

We think the biggest beneficiary of the development is Churchill Downs (CHDN). The company has been working hard to revitalize the thoroughbred horse racing industry, which hasn't been that healthy given the proliferation of off-track betting facilities and declining racing stock, but the inclusion of sports betting at its horse racing facilities across the country could be a significant boost, leveraging existing infrastructure and helping levels of profitability. Churchill Downs is moving fast. Just two days after the ruling, the company that shares its name with the legendary race track in Louisville, Kentucky, announced plans to offer sports betting in its casinos and online in New Jersey, Pennsylvania and Mississippi. Churchill Downs has a significant leg up on the competition, already owning the largest platform for online betting in horse racing in TwinSpires.com.

Several casino operators and suppliers rallied hard on the news, too, including Caesars Entertainment (CZR), William Hill (WIMHF), MGM Resorts (MGM), and Boyd Gaming (BYD), but we're not going to get ahead of ourselves. It seems like today, those of legal age can gamble on just about anything anywhere, and it remains to be seen whether most of the share of black-market sports betting activity will be picked up by the penny-slot operator at the local bar, or if it will encourage gambling fans to travel to the local casinos. Given the frequency of sporting events from baseball to basketball to football across amateur and professional ranks and beyond, it's likely that a local, more accessible venue may be the place for sports-betting "action" and not at the big casinos. In any case, it's hard not to view the ruling as a positive for casino operators and their suppliers, and a significant positive for Churchill Downs, in particular.

The Price-to-Earnings Ratio Demystified

Brian Nelson, CFA

The Price-to-Earnings Ratio Demystified

The price-to-earnings (PE) ratio seems so easy, right? The trailing PE is just the price per share of the stock divided by the annual net diluted earnings per share the firm generated in its last fiscal (calendar) year. The forward PE is the price per share of the stock divided by next fiscal (calendar) year's annual net diluted earnings per share of the firm (or the forward 12-month period).

The PE is probably the most common measure to help investors compare how cheap or expensive a firm's shares are, as stock prices, for lack of a better term, are arbitrary. For example, firms like Warren Buffett's Berkshire Hathaway (BRK.A), which has never split its stock, have traded over $300,000 per share, while other well-known companies like Sprint (S) can trade for just a few bucks per share. And Citigroup (C) was once a penny stock before its 10-to-1 reverse split in 2011. Apple (AAPL) is probably the most high-profile example. The company effected a 7:1 stock split June 2014.

It's only when investors compare a firm's share price to its annual net diluted earnings per share that they believe they can get a sense for whether a company's shares are expensive (overvalued, overpriced) or cheap (undervalued, underpriced). The higher the PE, it is believed the more expensive the company's stock--all else equal. This seems way too simple, so why would we (or better yet, how could we) devote so much time to talking about such a basic financial concept? Well, the truth is that the PE ratio is not as simple as you think (and even some of the most seasoned investors continue to use this powerful multiple incorrectly).

*The Price…*continued on next page

*The Price...*from previous page

How the PE Ratio Is Used Incorrectly

As Valuentum members know, the second pillar of our Valuentum Buying Index™ considers a company's forward PE ratio by comparing this measure to that of its industry peers to determine if the company is trading at a comparatively attractive valuation. *The forward PE in the 16-page stock reports represents the company's current stock price divided by its forward earnings per share.* If the firm's PE is lower than its peer median, an investor is paying less per unit of earnings than the median of its peer group. Investors are getting a good deal in this case, all else equal, right? Well, **the problem is that companies are never equal**, and even comparisons among firms that are in the same industry can be misleading, as they may have varying competitive advantages influencing the sustainability of earnings or require varying levels of reinvested capital to generate the same amount of earnings.

It is also inappropriate for investors to apply a firm's historical median (or average) price-to-earnings ratio to the same firm's future earnings stream. But why? It's the same stock. Shouldn't it be relevant and applicable? Well, yes and no. First, it's great for investors to have an idea of what "multiple range" a company has traded at in the past – there's a lot of value to this, and most relevant for cyclical firms (mainly industrials) that may, from a fundamental standpoint, exhibit similar (but not identical) patterns with respect to both earnings and their PE through the course of each economy cycle: think Boeing (BA) and the commercial aerospace cycle; Ford (F) and consumer demand for auto sales; or United Continental (UAL) with respect to premium air travel demand. But for less-cyclical firms (and even for cyclicals where structural industry dynamics have altered over time), investors are wrongly assuming that the forward outlook of the past (which determined the historical multiple) will be the same as the forward outlook of the present (which determines the current multiple). **This, unfortunately, is never true.**

So what is an investor to do? We know that it's imperfect to compare a firm's current or forward PE ratio to its peers or even to the median or average of its peers. No two firms are identical. And it's even more imperfect to compare a firm's current or forward price-to-earnings ratio to its historical measure. Look at Apple's outlook in 2002 versus its outlook in 2009 – a lot different, would you say? One wouldn't apply the same multiple to Apple's earnings in both years, or if one did, it would be for different reasons/underlying factors. We also believe that comparing a firm's PE to the average market multiple is imprecise. A firm is simply different than the aggregate market, so how can this comparison be significantly relevant?

Why Do We Use the PE Ratio

Okay, you may then ask: why does Valuentum use a PE ratio at all in its process if the measure is so imperfect? The answer rests in what drives stock prices. Not all investors use a discounted cash-flow process to value equities, and as a result, they resort to the short-form PE ratio to make decisions. There exists, as a result, what we'd describe to be self-fulfilling market forces (buying and selling) that make the price-to-earnings ratio a meaningful consideration. We call this "Behavioral Valuation."

In other words, if Portfolio Manager A likes a stock because its PE ratio is trading at the lower end of its historical PE valuation range or is trading at a discount to its peers' average PE, he/she might buy it, and this buying pressure itself causes the stock to rise, therefore making the PE in this form a relevant consideration for investors. This idea hits at the heart of the Valuentum process--striving to have an understanding of all market forces (investment philosophies) that drive stock prices, such that we can capitalize on them for members. For this reason, we include a relative value assessment in the Valuentum Buying Index, and the forward PE and PEG (price-earnings-to-growth) ratios, more specifically.

*The Price...*continued on next page

*The Price…*from previous page

Cash Flows Tell a More Accurate Story

So, with that said, how do we look at the PE? Valuentum followers know that we use a discounted cash-flow valuation process (the first pillar of our Valuentum Buying Index) to uncover the intrinsic worth of every company in our coverage universe. Okay, now you may ask: "Why do you use a free cash flow model when stock prices are driven by earnings?" After all, we just defined the stock price as a function of its earnings and a P/E multiple (the share price divided by net diluted earnings per share is the PE)? Well, yes. But earnings are a component of cash flow, and evaluating future free cash flows has its benefits (net income is a component of cash flow from operations).

For starters, the variations between earnings and cash flow not only arise in working capital changes over time (their influence on a firm's cash flow from operations), but also in the timing of the cost of replacing those assets that generate earnings (capital expenditures versus depreciation). Plus, varying levels of interest rates paid on debt loads can also muddy the water on earnings – not to mention that there are various analytical ways to account for rent expense (whether to capitalize such assets or to allow the expense to flow through the operating line). So there are some major differences between assessing a company's value based on earnings versus based on using a discounted cash-flow model. And because earnings quality (are earnings being converted to cash flow?) and capital efficiency (how much capital needs to be plowed back into the firm to maintain earnings) are critical to assessing the health of a company and its valuation, using free cash flow to evaluate companies is a better, more comprehensive process.

The DCF-Derived PE Ratio is Not Observed From Prices; It Is Derived From Cash Flows

As we outlined, a PE ratio is traditionally observed by dividing a company's stock price by its earnings to determine if the stock is cheap or expensive. For example, if a firm is trading at $100 per share and its net diluted earnings-per-share for next year is $10, the firm is trading at 10 times forward earnings. Many investors may say this stock is cheap in comparing it to the market multiple of ~13-16 times forward earnings, for example. We've addressed the pitfalls of doing so--every company is different with respect to expected sustainability of earnings and the capital-intensity required to generate such earnings and other factors. While the PE is an output in price-observed analysis (and in many quantitative applications), the discounted cash-flow model solves what the firm should be trading at on the basis of its unique fundamentals.

The discounted-cash-flow-derived PE (or value PE) represents the difference between saying a firm is trading at 20 times earnings, as in the case of a price-observed process, and saying a firm should be trading at 20 times earnings on the basis of its balance sheet and future expected free cash flows. A stock trading at 20 times may be cheap or expensive in the first case, but we know that a stock trading at 20 times is fairly valued in the second. The former represents the multiple that speculators are willing to pay for shares, while the latter represents what multiple to place on earnings to approximate what the company is worth. In order to solve the PE multiple that is most appropriate to place on a firm's earnings stream (its net diluted earnings per share), we must use a discounted cash flow process to do so. The "correct" PE cannot be observed in the market.

By calculating the present value of a company's future enterprise free cash flows (free cash flows to the firm), considering the firm's net balance sheet impact (cash less debt) and making other adjustments, one arrives at the company's intrinsic equity value. In dividing intrinsic equity value by diluted shares outstanding, the investor then arrives at equity value per share. Taking this equity value per share and dividing it by next fiscal year's earnings of the firm leaves you with the forward price-to-earnings (P/E) ratio. Because a discounted cash-flow process captures the unique intricacies of the exact firm one is modeling at the exact time one is modeling it (and taking into consideration all future factors at the time), it is far superior to any relative peer or historical PE multiple analysis.

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Why We're Fans of the Discounted Free Cash Flow Model

By now, you can probably see why we're such big fans of using a discounted free cash flow valuation model. Though there are many, many ways of looking at a stock—in fact, varying perspectives remain core to our process—using a free cash flow process is perhaps the only way investors can truly arrive at the "correct" intrinsic PE multiple to place on a company's earnings.

Let's examine this even further. Have you ever wondered why capital-light companies (software, advertising companies) garner higher earnings multiples than capital-intensive companies (auto manufacturers)? Well, capital-intensive companies have to re-invest a significant amount of earnings back into their businesses, thereby reducing future free cash flow, and by extension, the PE multiple that investors are willing to pay for that earnings stream. Simply put, not all earnings streams are created equal--even given equivalent future expected growth trajectories in them. Investors should prefer the earnings stream in this case that requires the least amount of re-invested maintenance capital.

The discounted cash-flow process is also going to uncover situations where the health of a firm's balance sheet will impact the correct PE multiple to place on a company's earnings stream. For example, all else equal, firms with billions in net cash should garner higher PE multiples than firms with billions in net debt. The net balance sheet position is captured in a discounted cash-flow process, but it is not readily apparent in any PE multiple assessment that only considers a firm's stock price and its earnings per share.

Nuts & Bolts

At this point, we hope that we have at least convinced you to be careful about arbitrarily placing a PE multiple on a firm's earnings to arrive at a target price (fair value). Even if that multiple is based on historical ranges (medians or averages) or is comparable to industry peers or the market as a whole, investors fall short of capturing the uniqueness of a company's future cash flow stream and balance sheet via a discounted cash flow process, which considers all of the qualitative factors of a company--from a competitive assessment to the company's efficiency initiatives and beyond. Using a discounted free cash flow model forces investors to think about the key valuation drivers of a company long into the future, thereby reinforcing forward-looking analysis and a critical understanding of what we'd describe as needle-moving inputs (revenue, WACC, etc.).

Without further delay, below is our complete definition of the PE ratio. This is the PE ratio that drives what a company *should* be trading at on the basis of its firm-specific fundamentals. You'll notice that the PE ratio is forward-looking and considers a variety of different components:

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}

Upon examination of the definition of the PE ratio above, one can see that a PE ratio is a short-form discounted cash-flow model. The numerator defines how one calculates the fair value estimate of a company's shares, while the denominator uses expected net diluted earnings per share. The discounted cash-flow process solves what a firm's shares should be trading at -- it represents the multiple that is applied to the company's earnings: the PE multiple.

What Are the Drivers of a Firm's Stock Price?

Because the PE ratio is also a function of the price of a stock as we outlined at the very beginning of this article (stock price divided by earnings), the factors of a discounted cash-flow model, the numerator of the definition above, are also the drivers behind the firm's stock price.

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*The Price…*from previous page

Below, we show how a number of qualitative factors influence the PE multiple and (by extension) stock prices and whether each factor is positively or negatively correlated to a company's intrinsic value and stock price. You'll notice the list is much more comprehensive than what many investors point to as the main reason for different PE ratios.

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)

Key Takeaways

The key takeaways are: 1) without using a discounted cash-flow model, the PE ratio that should be applied to a company's earnings stream can never be appropriately calculated, and by extension, 2) when investors assign an arbitrary price-to-earnings multiple to a company's earnings (based on historical trends or industry peers or the market multiple), they are essentially making estimates for all of the drivers behind a discounted cash-flow model in one fell swoop (and sometimes hastily).

As earnings for next year are often within sight and can be estimated with some confidence (though this certainly varies among firms), calculating the price-to-earnings ratio via a discounted cash-flow process, in our opinion, is of far greater importance than worrying about whether a firm will beat or miss earnings in its next fiscal year. Because the PE ratio is a discounted cash-flow model that considers the long-term qualitative dynamics of a particular entity, cash-flow analysis remains the first and most important pillar of our Valuentum Buying Index.

And finally, investors cannot ignore valuation analysis or the future. Valuation is an important driver behind stock prices, and it is based on future expectations that can only be estimated. This is just a fact of the markets. Thank you for reading.

How can we make this article better? Contact us at info@valuentum.com.

Study: Valuentum's Best Ideas Newsletter Portfolio

Download Valuentum's Best Ideas Newsletter Portfolio study at the following link:
https://www.valuentum.com/articles/Study_Valuentums_Best_Ideas_Newsletter_Portfolio

By Valuentum Analysts

VALUENTUM **SIMULATED**

BEST IDEAS NEWSLETTER PORTFOLIO

"Though we largely achieved the Best Ideas Newsletter portfolio's goals in advancing the newsletter portfolio each publication year (ends December 15) and achieving relative outperformance and risk-adjusted superiority to the benchmark, we may have done even better had our equity allocation been full during the measurement period."

President of Investment Research, Brian Nelson, CFA

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Average of Monthly Returns	
Best Ideas	S&P 500
1.20%	1.05%
Std. Dev. of Monthly Returns	
Best Ideas	S&P 500
2.68%	3.30%
Sharpe Ratio - 10-yr Treasury	
Best Ideas	S&P 500
1.31	0.91
Sharpe Ratio - 1-month T-bill	
Best Ideas	S&P 500
1.30	0.91
Best Ideas Newsletter Portfolio Beta	
Best Ideas vs. S&P 500	
0.67	
Correlation	
Best Ideas vs. S&P 500	
0.83	

See footnotes in Appendix.

Top Ideas - 12/15/2017	
Visa (V)	8.6%
Facebook (FB)	6.7%
Alphabet (GOOG, GOOGL)	6.0%
Berkshire Hathaway (BRK-B)	5.5%
SPDR S&P Dividend ETF (SDY)	4.7%

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Facebook (FB) – Page 1 of 16

Download Facebook's 16-page report, 2-page supplemental dividend report and read Valuentum's latest commentary on its website at www.valuentum.com.

By Valuentum Analysts

Valuentum Retail Equity Research | Visit us at www.valuentum.com | Ratings as of 6-Jun-2018 | Data as of 4-Jun-2018

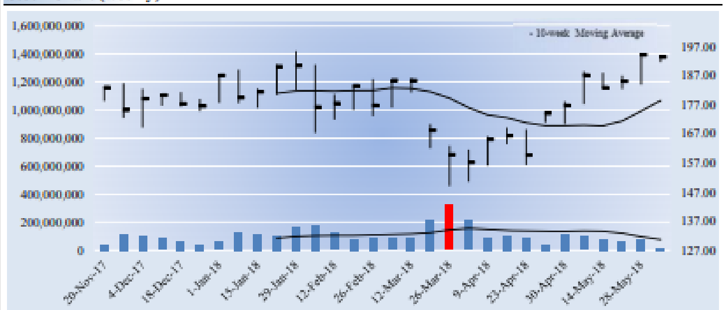
Facebook FB UNDERVALUED 3.5%

Buying Index™ 10 **Value Rating** ✓

Economic Castle	Estimated Fair Value	Fair Value Range	Investment Style	Sector	Industry
Very Attractive	$250.00	$200.00 - $300.00	MEGA-CAP BLEND	Information Technology	Internet Software & Svcs

Facebook's number of monthly active users (MAUs) is still growing at a solid double-digit rate, and its free cash flow generation and balance sheet health are simply incredible.

Stock Chart (weekly)



The week with the highest trading volume out of the last 30 weeks was a week of heavy selling, or distribution (red bar).

Investment Considerations	
DCF Valuation	UNDERVALUED
Relative Valuation	ATTRACTIVE
ValueCreation™	EXCELLENT
ValueRisk™	LOW
ValueTrend™	POSITIVE
Cash Flow Generation	STRONG
Financial Leverage	LOW
Growth	AGGRESSIVE
Technical Evaluation	BULLISH
Relative Strength	STRONG
Money Flow Index (MFI)	NEUTRAL
Upside/Downside Volume (U/D)	BEARISH
Near-term Technical Support, 10-week MA	178.00

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

Business Quality (ValueCreation™)

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

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

Company Vitals	
Market Cap (USD)	$571,336
Avg Weekly Vol (30 wks)	107,632
30-week Range (USD)	149.02 - 195.32
Valuentum Sector	Information Technology
5-week Return	9.0%
13-week Return	15.4%
30-week Return	8.1%
Dividend Yield %	0.0%
Dividends per Share	0.00
Forward Dividend Payout Ratio	0.0%
Est. Normal Diluted EPS	11.31
P/E on Est. Normal Diluted EPS	17.1
Est. Normal EBITDA	45,394
Forward EV/EBITDA	17.2
EV/Est. Normal EBITDA	11.7
Forward Revenue Growth (5-yr)	23.1%
Forward EPS Growth (5-yr)	22.7%

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

Returns Summary	3-year Historical Average
Return on Equity	17.6%
Return on Assets	15.8%
ROIC, with goodwill	48.0%
ROIC, without goodwill	116.9%

ROIC = Return on Invested Capital; NMF = Not Meaningful

Leverage, Coverage, and Liquidity

In Millions of USD

Total Debt	0
Net Debt	-41,711
Total Debt/EBITDA	0.0
Net Debt/EBITDA	NMF
EBITDA/Interest	Excellent
Current Ratio	12.9
Quick Ratio	12.6

NMF = Not Meaningful

Investment Highlights

• Facebook's mission is to make the world more open and connected. People use Facebook to stay in touch with friends/family, to learn about the latest news, and to share and express what matters to them. CEO Mark Zuckerberg is a true visionary, and his genius may not yet be fully on display. The company was founded in 2004 and is headquartered in California.

• It's unfair to lump Facebook in with other social media companies. Facebook is generating tens of billions in revenue and is throwing off gobs of excess free cash flow. The company's balance sheet is pristine with nearly $42 billion in cash and no debt at the end of 2017.

• Facebook's number of mobile users continues to grow, with mobile ad revenue accounting for 88% of total ad revenue in 2017, up from 83% in 2016. Data privacy and security remain paramount. It recently found itself painted in a bad light with the Cambridge Analytica scandal, but we don't think the setback will have a material impact on the long-term trajectory of free cash flows.

• While Facebook's free cash flow generation and balance sheet strength are strong sources of reassurance, investors must be cognizant of the low barriers to entry in the social media space as well as the potentially fickle nature of its users. The social media landscape could be completely different in 5-10 years, presenting both risks and opportunities.

• Facebook's monthly active users (MAUs) count is still growing at a tremendous rate. Overall MAUs sat at 2.13 billion as of the end of 2017, while its daily active user base was 1.40 billion, both of which represent 14% growth from a year earlier.

Relative Valuation	Forward P/E	PEG	Price / FV
Alphabet	25.7	1.9	82.8%
Baidu	24.8	2.1	111.2%
Twitter	52.7	NMF	110.0%
Ultimate Software	44.8	6.2	111.2%
Peer Median	35.2	2.1	110.6%
Facebook	**24.9**	**1.6**	**77.3%**

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

Financial Summary	----- Actual -----		Projected
Fiscal Year End:	Dec-16	Dec-17	Dec-18
Revenue	27,638	40,653	56,630
Revenue, YoY%	54.2%	47.1%	39.3%
Operating Income	12,427	20,203	26,566
Operating Margin %	45.0%	49.7%	46.9%
Net Income	10,188	15,920	22,899
Net Income Margin %	36.9%	39.2%	40.4%
Diluted EPS	3.48	5.39	7.75
Diluted EPS, YoY %	170.8%	54.6%	43.8%
Free Cash Flow (CFO-capex)	11,617	17,483	13,895
Free Cash Flow Margin %	42.0%	43.0%	24.5%

In Millions of USD (except for per share items)

Structure of the Internet Software & Services Industry NEUTRAL

The Internet software/services industry is composed of a variety of companies with rapidly-changing business models. Most focus on improving the ways people connect with information, either via Internet search or by social media platforms, and generate revenue primarily by delivering cost-effective online advertising. Constituents earn significant returns on invested capital due to their capital-light operations, though competition remains fierce. We expect most companies in this group to look substantially different 10 years from now than they do today. Overall, we're neutral on the structure.

Booking Holdings (BKNG) – Page 1 of 16

Download Booking Holdings' 16-page report, 2-page supplemental dividend report and read Valuentum's latest commentary on its website at www.valuentum.com.

By Valuentum Analysts

Valuentum Retail Equity Research | Visit us at www.valuentum.com | Ratings as of 15-Jun-2018 | Data as of 8-Jun-2018

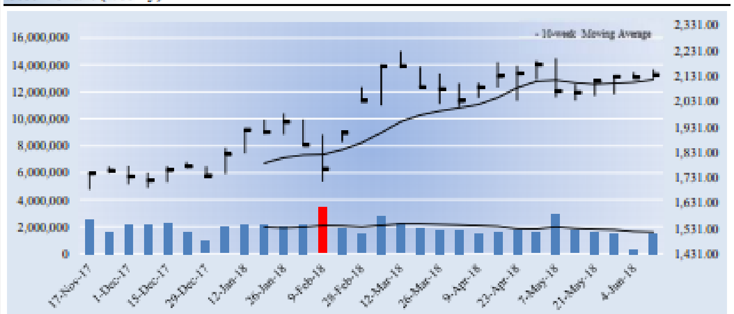
Booking Holdings BKNG FAIRLY VALUED

Valuentum **Buying Index™** 6 | Valuentum **Value Rating**

Economic Castle	Estimated Fair Value	Fair Value Range	Investment Style	Sector	Industry
Highest Rated	$2104.00	$1683.00 - $2525.00	LARGE-CAP GROWTH	Consumer Discretionary	Internet & Catalog Retail

Demand in Booking Holdings' business model is boosted by a virtuous cycle, but shares can be volatile around quarterly earnings reports due in part to management's habit of issuing conservative guidance.

Stock Chart (weekly)



The week with the highest trading volume out of the last 30 weeks was a week of heavy selling, or distribution (red bar).

Investment Considerations	
DCF Valuation	FAIRLY VALUED
Relative Valuation	UNATTRACTIVE
ValueCreation™	EXCELLENT
ValueRisk™	LOW
ValueTrend™	POSITIVE
Cash Flow Generation	STRONG
Financial Leverage	MEDIUM
Growth	HIGH
Technical Evaluation	BULLISH
Relative Strength	NEUTRAL
Money Flow Index (MFI)	NEUTRAL
Upside/Downside Volume (U/D)	BULLISH
Near-term Technical Support, 10-week MA	2117.00

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

Business Quality

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

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

Company Vitals	
Market Cap (USD)	$104,637
Avg Weekly Vol (30 wks)	1,897
30-week Range (USD)	1683.275 - 2228.99
Valuentum Sector	Consumer Discretionary
5-week Return	3.4%
13-week Return	-1.2%
30-week Return	26.5%
Dividend Yield %	0.0%
Dividends per Share	0.00
Forward Dividend Payout Ratio	0.0%
Est. Normal Diluted EPS	117.21
P/E on Est. Normal Diluted EPS	18.2
Est. Normal EBITDA	7,579
Forward EV/EBITDA	17.5
EV/Est. Normal EBITDA	14.1
Forward Revenue Growth (5-yr)	11.8%
Forward EPS Growth (5-yr)	25.5%

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

Returns Summary	3-year Historical Average
Return on Equity	24.8%
Return on Assets	12.5%
ROIC, with goodwill	88.4%
ROIC, without goodwill	196.0%

ROIC = Return on Invested Capital; NMF = Not Meaningful

Leverage, Coverage, and Liquidity

In Millions of USD

Total Debt	9,524
Net Debt	2,122
Total Debt/EBITDA	1.9
Net Debt/EBITDA	0.4
EBITDA/Interest	19.6
Current Ratio	2.6
Quick Ratio	2.5

NMF = Not Meaningful

Investment Highlights

- Booking Holdings is a leader in global online hotel reservations. The firm is composed of four primary brands--Booking.com, Booking Holdings.com, Agoda.com, Kayak and Rentalcars.com--and several ancillary brands. Booking growth continues to be excellent across its platforms. The company was founded in 1997 and is headquartered in Connecticut.
- Demand in Booking Holdings' business model is boosted by a virtuous cycle. Its partnerships allow it to offer an enhanced customer experience, driving increased conversion and traffic. Growing traffic levels give it the opportunity to test and improve customer and partner satisfaction.
- Booking Holdings has made a habit of issuing conservative quarterly guidance, which the market tends not to like. Investors should be prepared for material swings on quarterly reports due to such guidance, and the firm's equity may be better served by management not issuing such punitive quarterly guidance. Nevertheless, we continue to have confidence in the firm's fundamentals.
- Priceline changed its name to Booking Holdings to align itself with its largest subsidiary, Booking.com. Booking.com accounts for the majority of its gross bookings and operating income with more than 1.5 million listed properites and an average of 1 million bookings per day. Management has hinted that it may be open to acquisitions to further expand its portfolio.
- As it rides the wave of secular growth in Internet penetration in travel, Booking Holdings will also benefit from expansion into new markets in North America, the Asia Pacific, and South America. The company's strong brand helps prop up share in the mature US market.

Relative Valuation	Forward P/E	PEG	Price / FV
Alibaba	31.4	1.7	87.3%
Amazon.com	NMF	4.2	86.9%
eBay	17.5	NMF	106.0%
Expedia Group	23.3	1.8	94.4%
Peer Median	23.3	1.8	90.9%
Booking Holdings	**24.0**	**1.8**	**101.5%**

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

Financial Summary	----- Actual -----		Projected
Fiscal Year End:	Dec-16	Dec-17	Dec-18
Revenue	10,743	12,431	14,544
Revenue, YoY%	16.5%	15.7%	17.0%
Operating Income	3,847	4,538	5,627
Operating Margin %	35.8%	36.5%	38.7%
Net Income	2,135	2,341	4,369
Net Income Margin %	19.9%	18.8%	30.0%
Diluted EPS	42.65	46.86	89.20
Diluted EPS, YoY %	-13.8%	9.9%	90.4%
Free Cash Flow (CFO-capex)	3,764	4,374	4,783
Free Cash Flow Margin %	35.0%	35.2%	32.9%

In Millions of USD (except for per share items)

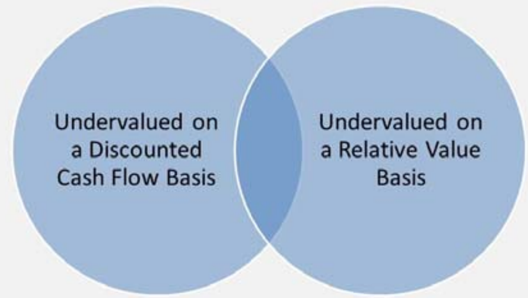
Structure of the Internet & Catalog Retail Industry **GOOD**

The Internet and catalog retail industry benefits as a whole from the secular trend toward consumer digital (online) consumption. The industry consists of a number of exclusive online retailers led by Amazon, which continues to disrupt the broader retail space, and businesses that offer Internet travel services such as Booking Holdings, while online auctions are dominated by eBay. The industry generates high returns on investment due to minimal capital costs, but the landscape will be vastly different in the decades ahead. Still, we like the group.

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 and UNATTRACTIVE relative value ratings.]

You'll notice there are not many ideas in this market that pass this stringent "value" test. We continue to emphasize that some of our best ideas are included in our simulated newsletter portfolios.

Company Name	Symbol	DCF Valuation	Relative Valuation	Price / Fair Value	Fair Value Estimate
General Motors	GM	UNDERVALUED	NEUTRAL	0.72	$61.00
Discover Financial	DFS	UNDERVALUED	UNATTRACTIVE	0.76	$102.00
Verint	VRNT	UNDERVALUED	NEUTRAL	0.78	$54.00
General Electric	GE	UNDERVALUED	NEUTRAL	0.67	$20.00
Southwestern Energy	SWN	UNDERVALUED	NEUTRAL	0.47	$9.00
AIG	AIG	UNDERVALUED	ATTRACTIVE	0.78	$69.00
Facebook	FB	UNDERVALUED	ATTRACTIVE	0.77	$250.00
Finisar	FNSR	UNDERVALUED	UNATTRACTIVE	0.75	$22.00
Gilead Sciences	GILD	UNDERVALUED	NEUTRAL	0.66	$98.00
SCANA	SCG	UNDERVALUED	UNATTRACTIVE	0.70	$53.00

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

*Ideas...*continued on next page

*Ideas…*from previous page

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

We also show firms that register a 1 on the 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 making driving up prices, Facebook (FB) is the only company that registers either 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.**

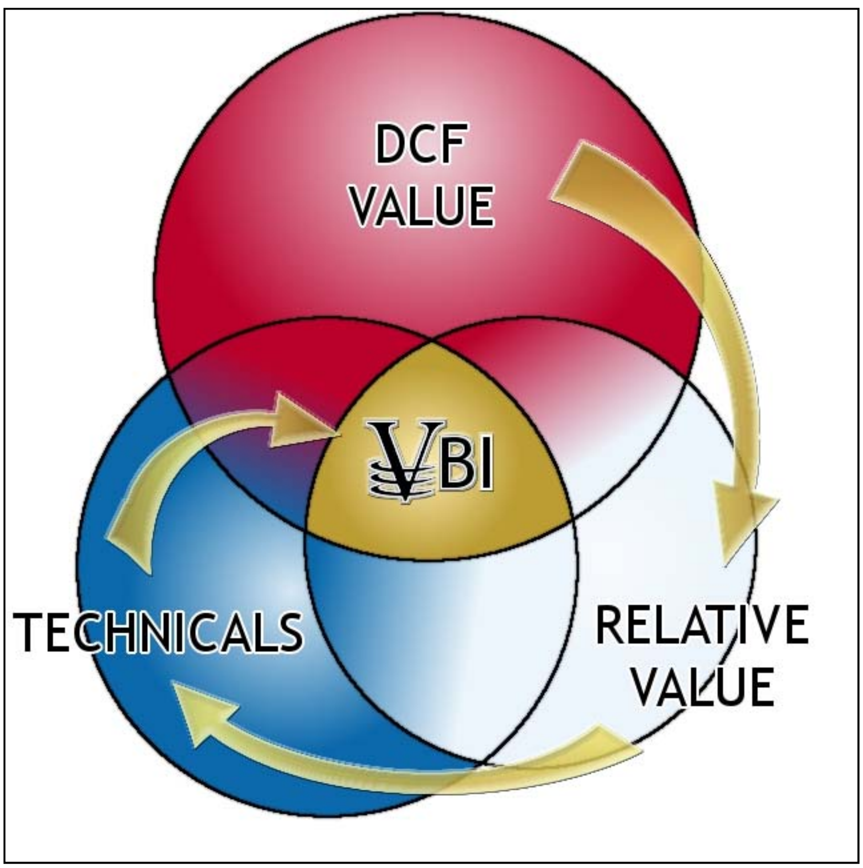
Company Name	Symbol	Sector	VBI
Amphenol Corp	APH	Information Technology	1
Arch Capital	ACGL	Financials	1
Boyd Gaming	BYD	Consumer Discretionary	1
Churchill Downs	CHDN	Consumer Discretionary	1
Clorox	CLX	Consumer Staples	1
Fiserv	FISV	Information Technology	1
Graco	GGG	Industrials	1
H&E Equipment	HEES	Industrials	1
Illinois Tool Works	ITW	Industrials	1
Intercontinental	IHG	Consumer Discretionary	1
Intl Flavors	IFF	Materials	1
J&J Snack	JJSF	Consumer Staples	1
Jack Henry	JKHY	Information Technology	1
Kohl's	KSS	Consumer Discretionary	1
Martin Marietta	MLM	Industrials	1
Mettler-Toledo	MTD	Health Care	1
MGE Energy	MGEE	Energy	1
Nordson	NDSN	Industrials	1
OmegaFlex	OFLX	Industrials	1
Owens Corning	OC	Industrials	1
Raytheon	RTN	Industrials	1
RBC Bearings	ROLL	Industrials	1
SBA Comm	SBAC	Telecom Services	1
Sun Hydraulics	SNHY	Industrials	1
Synopsys	SNPS	Information Technology	1
Teledyne	TDY	Industrials	1
Teradyne	TER	Information Technology	1
ViaSat	VSAT	Information Technology	1

Our Methodology – The Valuentum Buying Index (VBI)

By Valuentum Analysts

At Valuentum, we think some of the best opportunities arise from an understanding of a variety of investing disciplines in order to identify the most attractive stocks at any given time. Valuentum therefore analyzes each stock across a wide spectrum of philosophies, from deep value through momentum investing. We think companies that are attractive from a number of investment perspectives--whether it be growth, value, income, momentum, etc.--have the greatest probability of capital appreciation and relative outperformance. The more deep-pocketed institutional investors that are interested in the stock for reasons based on their respective investment mandates, we posit the more likely it will be bought and the more likely the price will move higher to converge to its "true" intrinsic value (buying a stock pushes its price higher). On the other hand, we think the worst stocks will be shunned by most investment disciplines and display expensive valuations, poor technicals and deteriorating momentum indicators.

We think stocks that meet our demanding criteria fall in the center of the Venn diagram below, displaying attractive characteristics from a discounted cash-flow basis, a relative value basis, and with respect to a technical and momentum assessment. The size of the circles generally reveals the relative emphasis we place on each investment consideration, while the arrows display the order of our process -- value first then technicals and momentum last. We may like firms that are undervalued both on a discounted cash flow (DCF) basis and relative value basis, but we won't like firms just because they're currently exhibiting attractive technical or momentum indicators. We're not traders or speculators. We target the long term, and we want to have a strong process to support the ideas we deliver to our subscribers.



Our Methodology – The Valuentum Buying Index continued on next page

Our Methodology – The Valuentum Buying Index continued from previous page

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

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

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

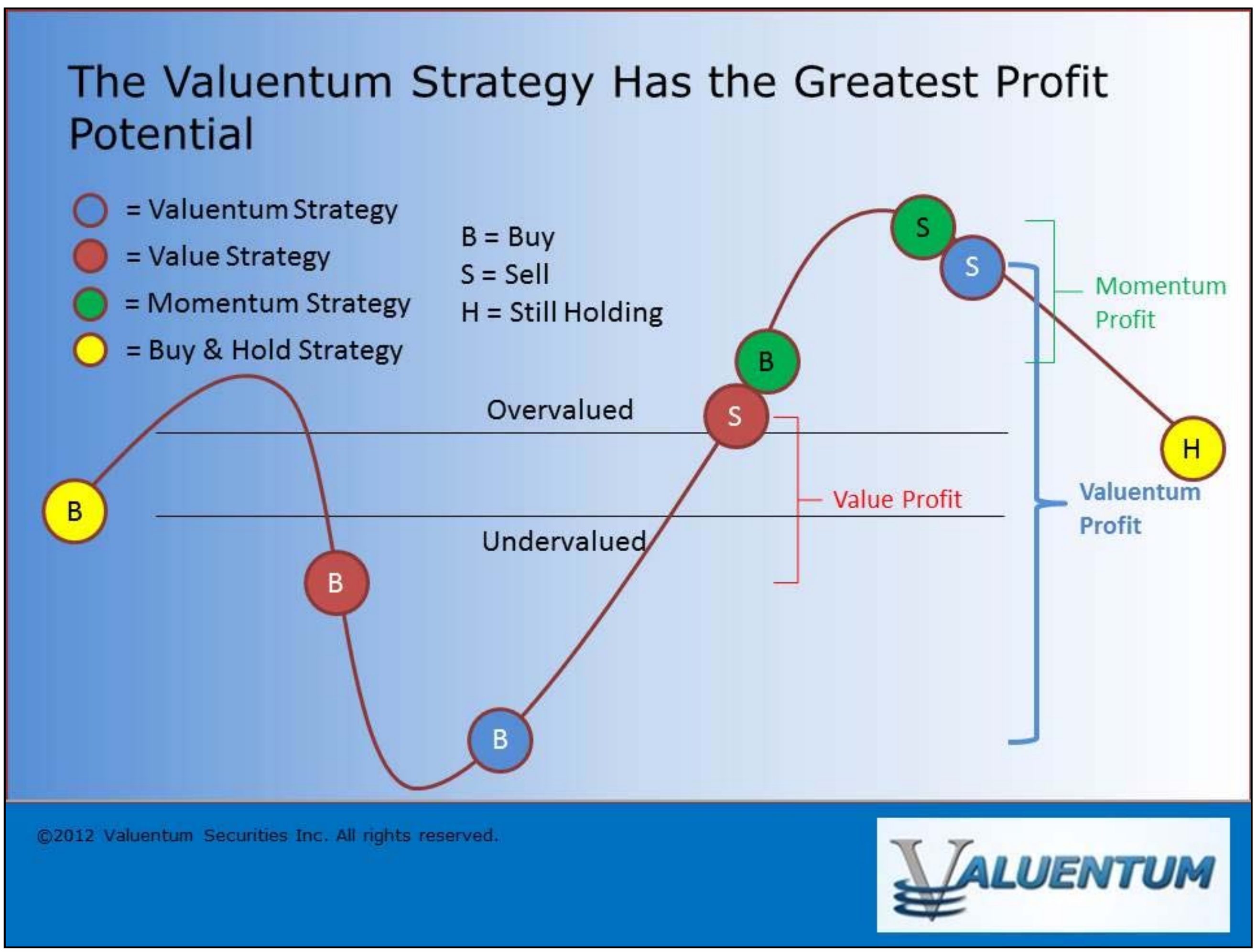


Illustration for educational purposes only.

Our Methodology – The Valuentum Buying Index continued on next page

Our Methodology – The Valuentum Buying Index continued from previous page

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

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

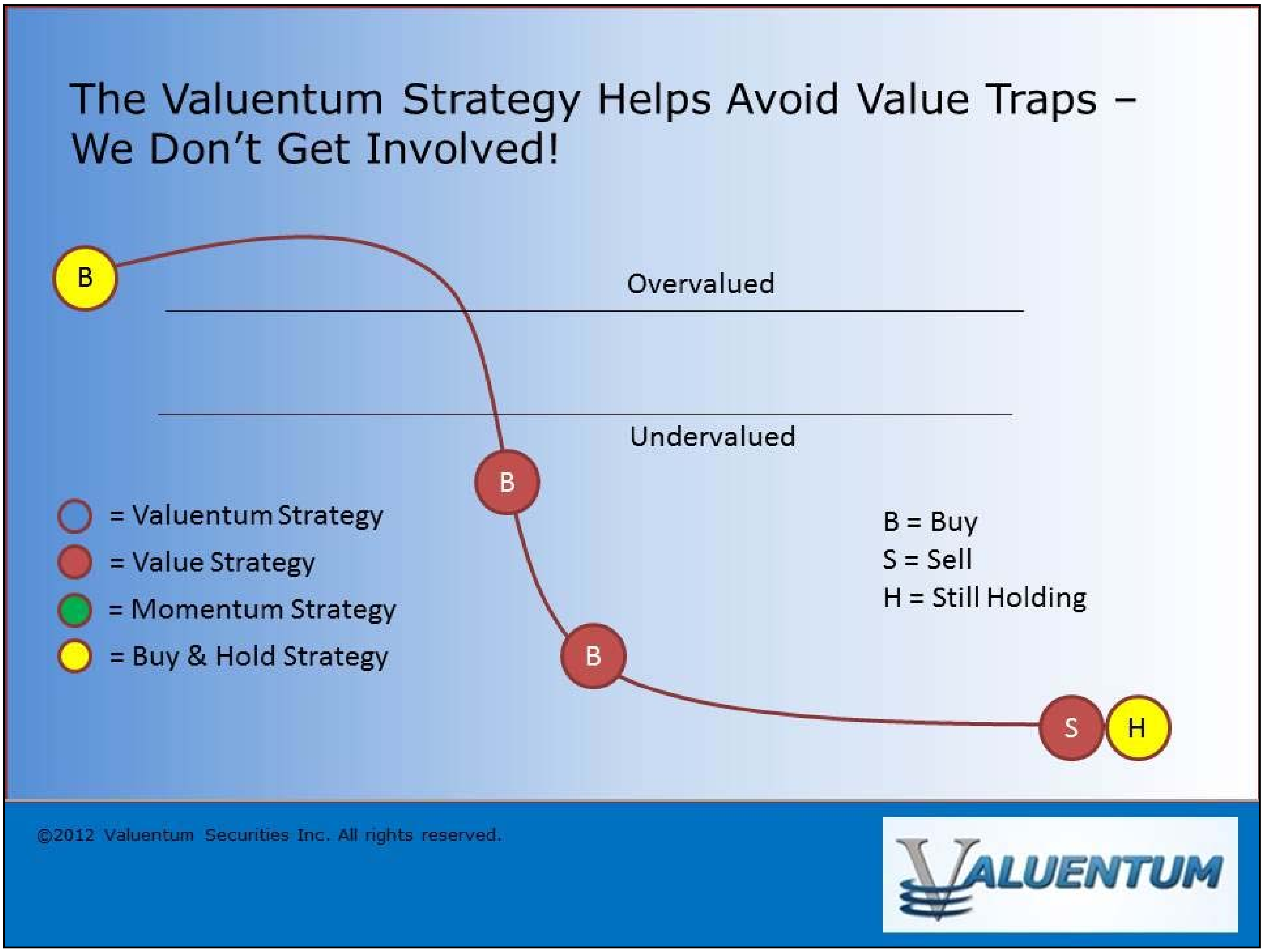


Illustration for educational purposes only.

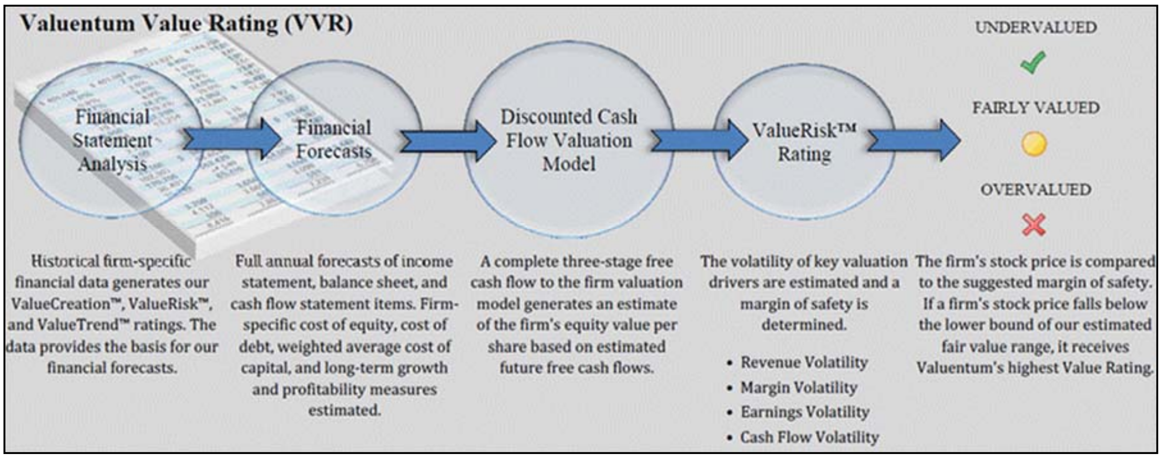
Our Methodology – The Valuentum Buying Index continued on next page

Our Methodology - The Valuentum Buying Index continued from previous page

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

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

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



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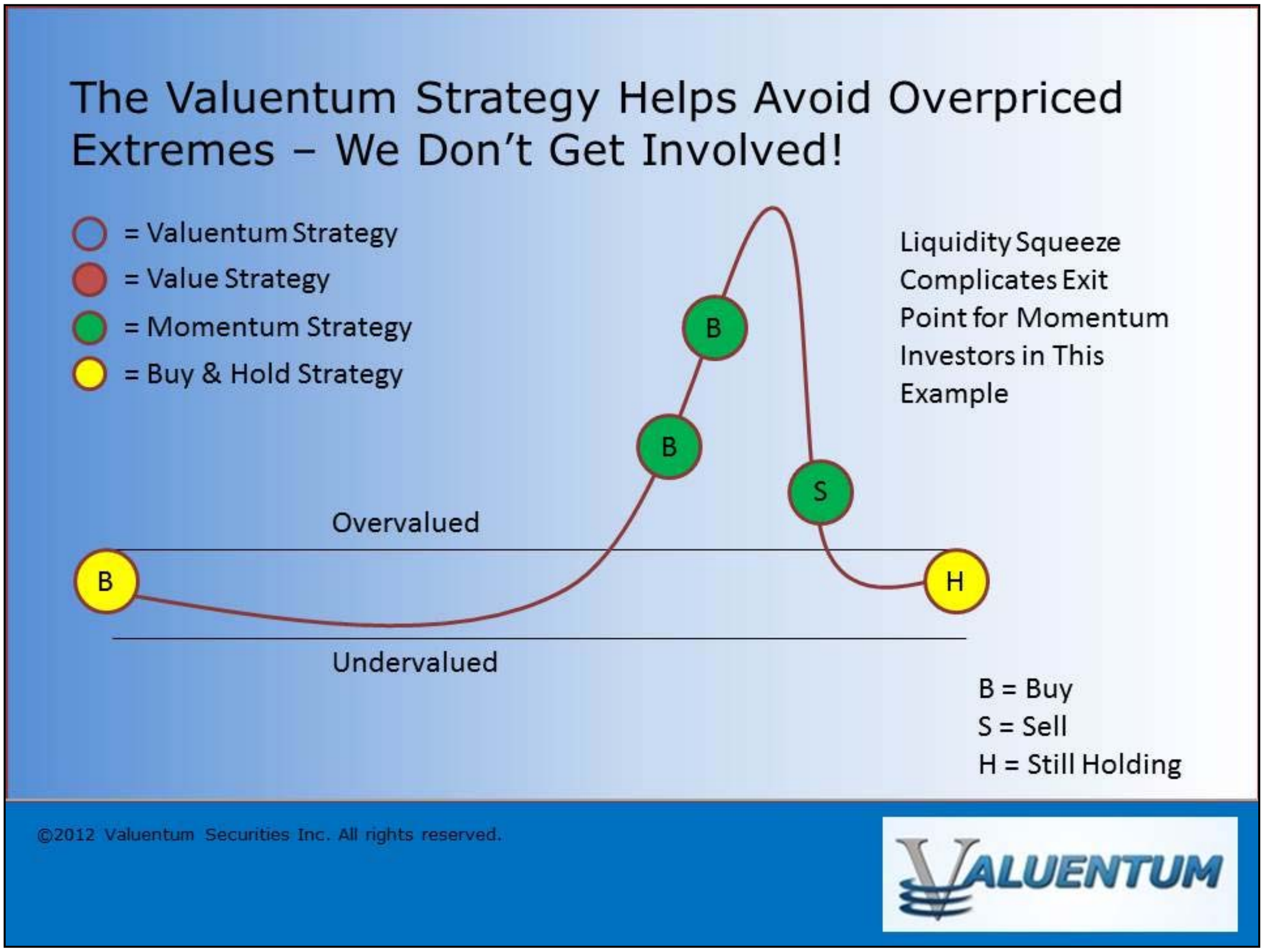
After evaluating historical trends, we then make full annual forecasts for each item on a company's income statement and balance sheet to arrive at a firm's future free cash flows. We derive a company-specific cost of equity (using a fundamental beta based on the expected uncertainty of key valuation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

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

We think a focus on discounted cash-flow (DCF) valuation helps to prevent investors from exposing their portfolios to significantly overpriced stocks at their peaks. The image below reveals how pure momentum investors may expose their portfolios to pricing extremes and dramatic falls (green circles: Buy --> Sell). The Valuentum Buying Index attempts to steer clear from these situations.

Our Methodology - The Valuentum Buying Index continued on next page

Our Methodology – The Valuentum Buying Index continued from previous page



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

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

III. The Valuentum Buying Index Seeks to Avoid Value Traps, Falling Knives and Opportunity Cost

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

Our Methodology – The Valuentum Buying Index continued on next page

Our Methodology – The Valuentum Buying Index continued from previous page

valuation criteria).

Rigorous valuation analysis and technical analysis are not mutually exclusive, and we believe both can be used together to bolster 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.

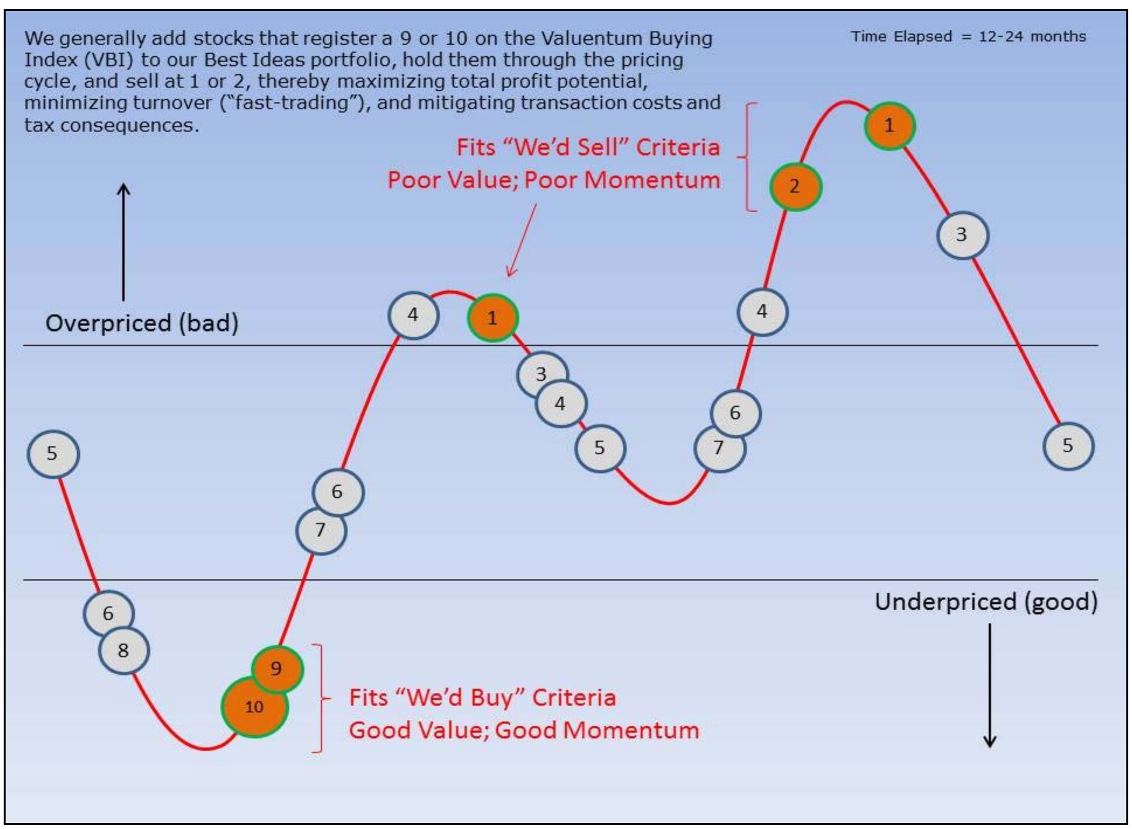


Illustration for educational purposes only.

Our Methodology – The Valuentum Buying Index continued on next page

Our Methodology – The Valuentum Buying Index **continued from previous page**

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.

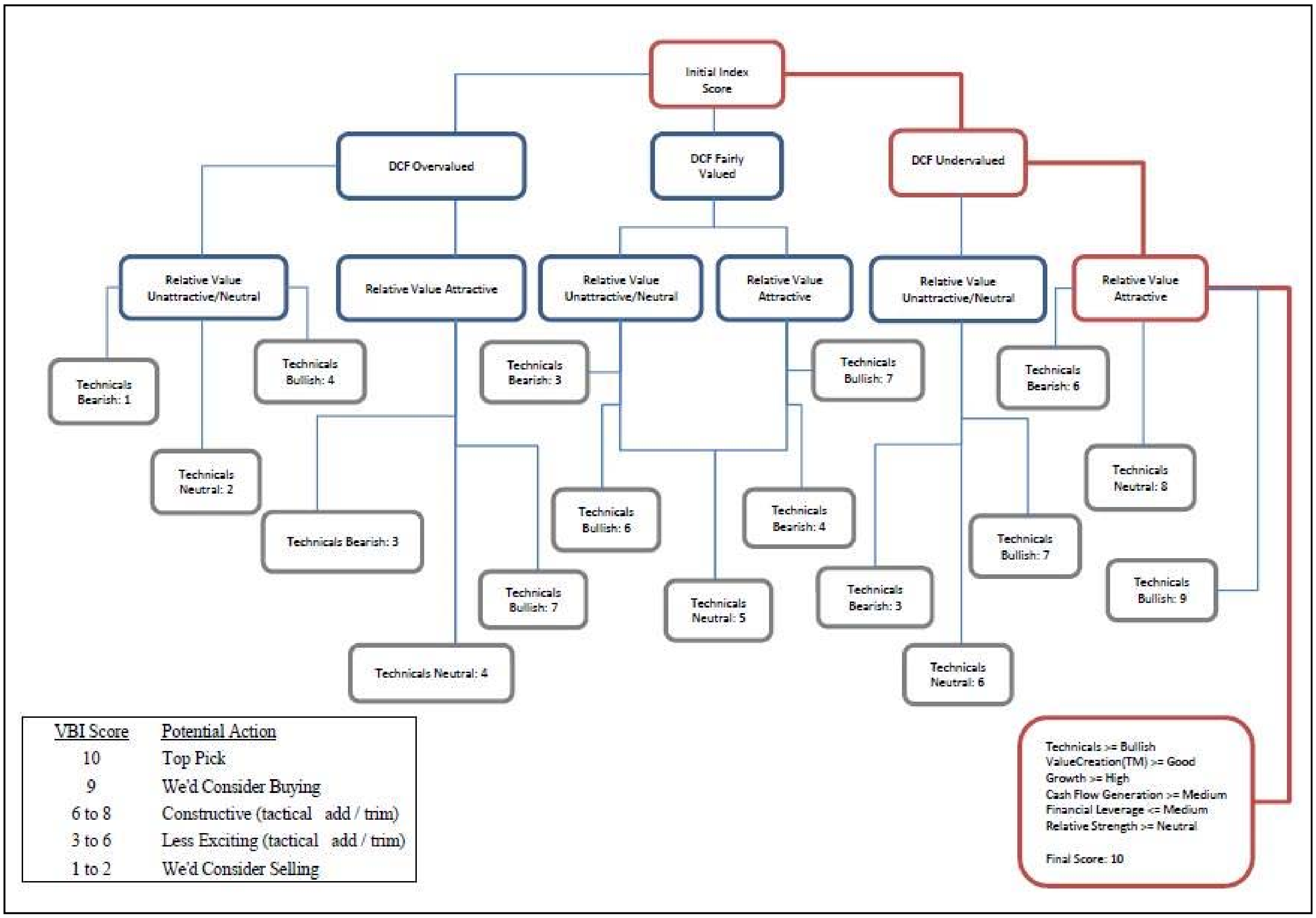


Illustration for educational purposes only.

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?

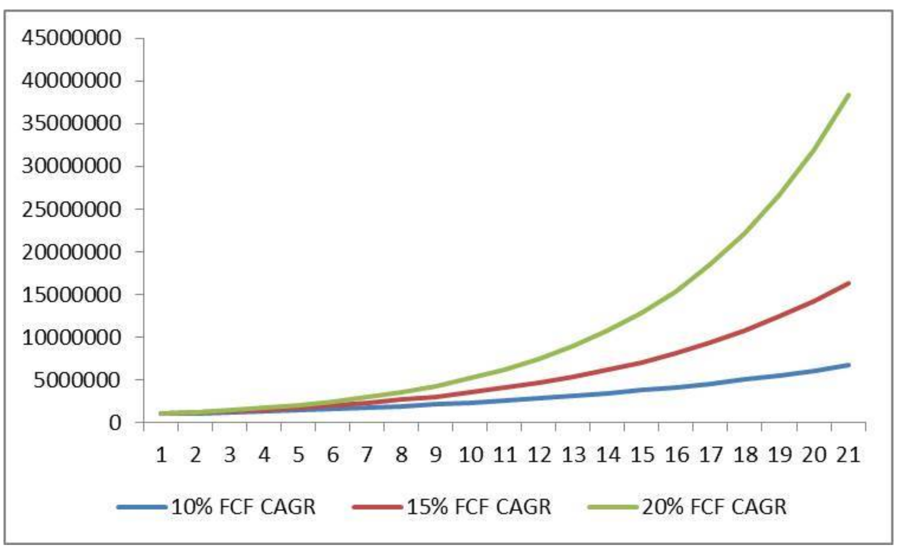
One of the most important concepts of the Valuentum methodology (and valuation in general) is the understanding that the value of a company is a range of probable valuation outcomes, not a single point estimate. Even well-seasoned stock analysts are guilty of saying that a company's shares are worth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



About the Fair Value Range continued on next page

About the Fair Value Range **continued from previous page**

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.

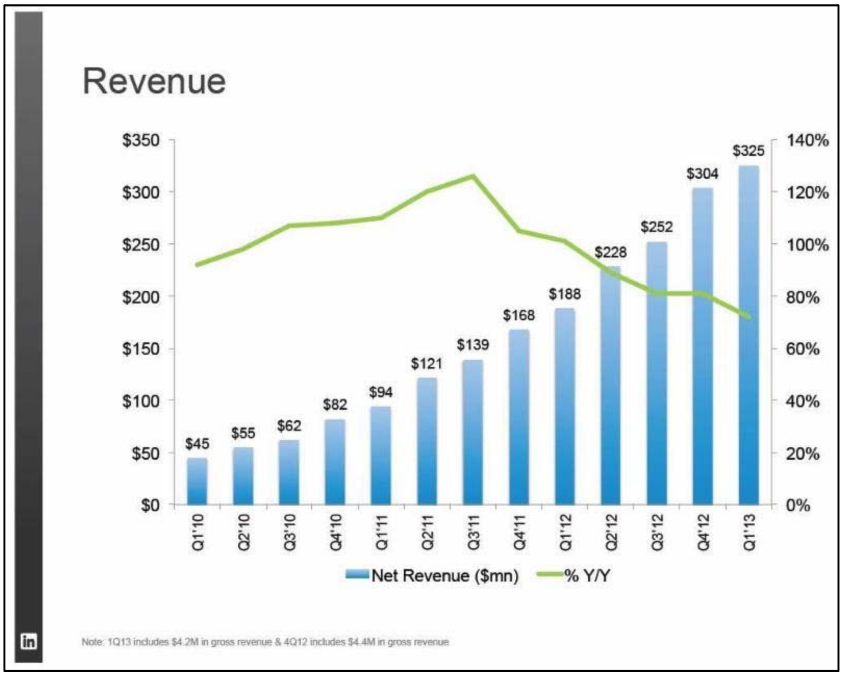


Image Source: LinkedIn

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.

About the Fair Value Range **continued on next page**

About the Fair Value Range **continued from previous page**

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

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

How We Use continued from previous page

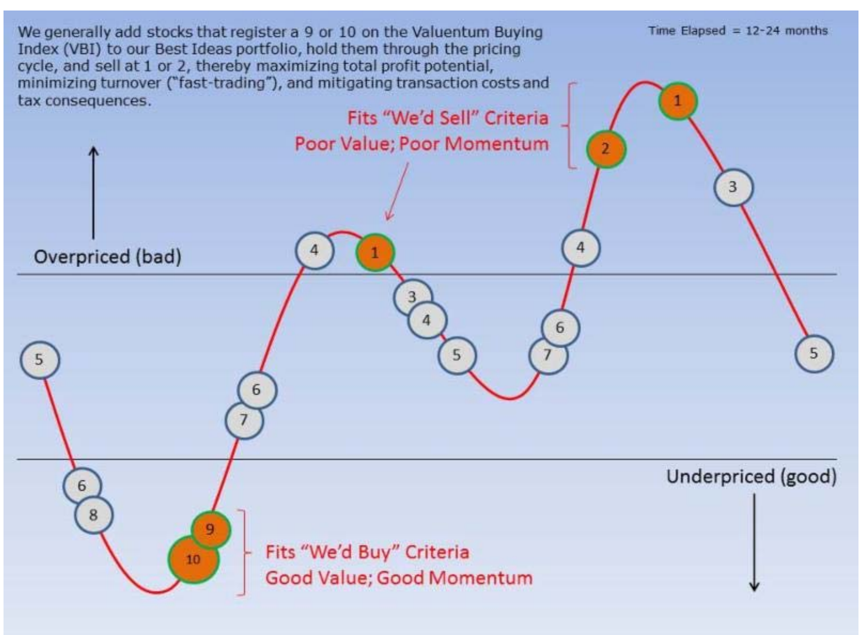
may be the secret to success in investing, a lot could have gone wrong with the temptation to do something each day. Obviously, we're very disciplined, but we also credit the portfolio outperformance to the VBI methodology itself. It is a very helpful tool.

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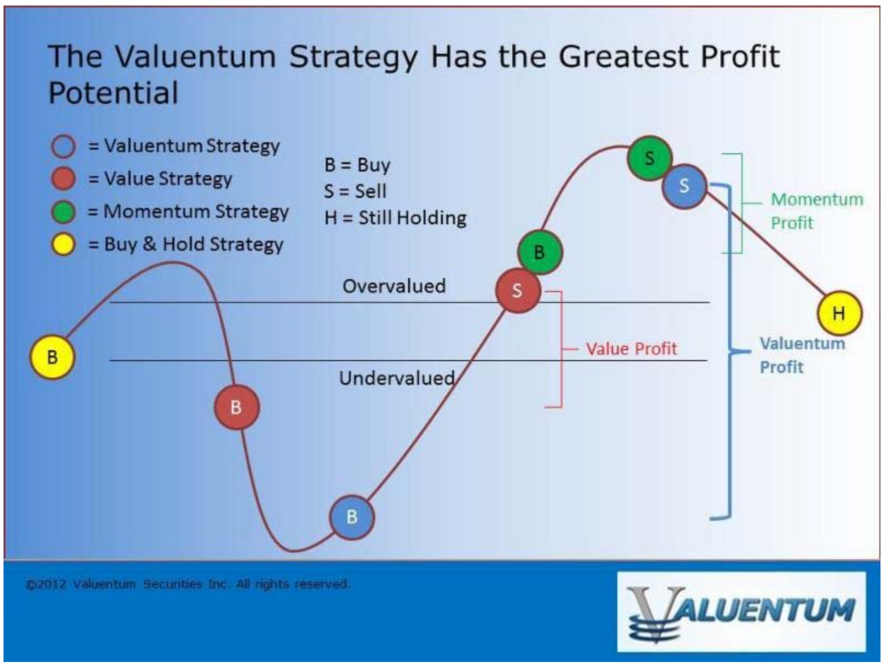
But why don't we churn our ideas by updating daily and trading a lot? Obviously, we don't think that's the secret to investment success. In quite the opposite approach, we strive to maximize profits on every idea that we pursue, with the understanding that momentum does exist and that prices over and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

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

How We Use continued from previous page

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, 1992

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 8, Issue 6

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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.