OUR BEST IDEAS NEWSLETTER

Valuentum Securities

Stock Analysis: From Value through Momentum Investing

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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.

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> "This has been clearly reflected in the volatility in equity markets on repeated news of potentially increased tariffs among major global players, and we fully expect such volatility to persist as trade posturing continues on a significant scale."
>
> – Kris Rosemann

More Tariff Talk Keeps Markets Volatile

By Kris Rosemann

As with many developments surrounding the Chinese (FXI, MCHI) economy, metals have found themselves at the fore of the discussion. After the Trump Administration threatened additional 10% tariffs on $200 billion in Chinese imports July 10, copper (COPX) and other metals prices plunged as the newest list of targeted goods includes manufacturing export industries, electronics, textiles, metal components, and auto parts. It is worth noting that the US imports far more Chinese goods than vice versa, suggesting China would not be able to match US tariffs dollar-for-dollar if a full-on trade war ensues, though such a scenario is not a best-case outcome for either side.

Though volatile in the first half of 2018, due in part to ongoing trade concerns, copper prices had risen considerably since early 2016, thanks in part to expectations of rising demand from autonomous vehicles. However, demand concerns are cropping up alongside more tariff talk from the Trump administration as the resulting price hikes are expected to ultimately be passed on to consumers, which has the potential to mitigate previously anticipated demand increases in the near term. Metal-heavy consumer products such as cars and air conditioners are prime examples of such a shift, and China is a key buyer of most industrial metals. Producers up and down the supply chain are likely to feel the impact of rising input costs and/or falling demand as a result.

Textile stocks also faced pressure on the news of potential new tariffs, as have semiconductor stocks as Chinese products from TV parts to refrigerators may be included in the proposed next round of tariffs. Trump's actions may be little more than political posturing among his voter base, which generally appears to support his 'America First' agenda on the surface, a driver that may change quickly should consumer prices experience a material inflection upward. Political considerations cannot be ignored as US mid-term elections near.

Many multinational corporations are also likely to delay major investments until the dust settles, yet another potentially negative externality of the Trump administrations actions. Comments from SoftBank (SFTBY) officials

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may not have mitigated this concern, but rather highlight the somewhat selective impact of the tariffs as the company remains confident that its global investments in next-generation technology such as artificial intelligence, the Internet of Things, and robotics are unlikely to be impacted by the trade war. We're not ruling anything out at this juncture in a wildly unpredictable space driven by political issues.

Next-generation technology may not be entirely unaffected by the escalating trade war as some of the semiconductors stocks facing selling pressure, including simulated newsletter portfolios idea Intel (INTC), are tied in part to some of the aforementioned technology. Even if such technology is not directly impacted by the growing list of tariffs, the overall profit pool of semiconductors is a reasonably important consideration as it relates to the ongoing development of other parts of their portfolios. Chinese tech stocks listed on US exchanges, such as Alibaba (BABA) and JD.com (JD), are also facing selling pressure as the possibility for tariffs on a growing range of tech products grows higher with each report of the Trump administration's desire for additional trade-restricting policies.

Auto manufacturers have already been at the fore of the tariff developments, though through US-EU trade disputes. Harley Davidson (HOG) found itself caught in Trump's crosshairs after it announced plans to shift production to Europe in response to the trade dispute. The motorcycle maker estimates that tariffs will add ~$2,200 on average to the cost of motorcycles produced in the US and exported to the EU and could cost the company $90-$100 million in 2018 alone. The production shift to Europe will require material investments and is a prime example of the fallout consumers might expect to see as developments unfold, though shifting production to China is admittedly a more difficult proposition for US companies than moving manufacturing to Europe.

The crude oil market (OIL, USO) is yet another area of sensitivity following the new tariff talks as an impact on overall global demand growth is a possibility. China is the second largest importer of US crude, but oil has yet to be a target area in Beijing's retaliatory procedures. Also impacting the price of crude of late is the EIA reiterating its opinion that the US will continue to play an increasingly important role in the global supply of the black liquid as the EIA released a forecast estimated the US will average 12 million barrels of production per day in 2019, which would make the country the world's leading producer. Nevertheless, potential logistical issues in the Permian Basin, perhaps the most important regions of US oil production, have the potential to impact this forecast and are worth monitoring. Potential production increases from the likes of Saudi Arabia and Libya are impacting outlooks as well.

Though we do not disagree with SoftBank's position that certain areas of global investments may not be impacted by escalating trade tensions, global economic growth in general does not benefit from growing trade restrictions among the world's largest economies. This has been clearly reflected in the volatility in equity markets on repeated news of potentially increased tariffs among major global players, and we fully expect such volatility to persist as trade posturing continues on a significant scale.

Indexing Moves Markets and Creates Inefficiencies

By Brian Nelson, CFA

Full Text: https://www.valuentum.com/downloads/20180706/download

How can one start a paper on whether indexing moves the market and creates inefficiencies without explaining how the market works in the first place? Stock prices are, for the most part, driven higher or lower by buying and selling activity, respectively, plain and simple.

The market does not discriminate between who is doing the buying and selling, but stock prices are driven accordingly on buying and selling actions, irrespective of whether the buyer is an index fund or an active fund manager, or other.

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Stock prices aren't set magically by a wizard behind the curtain. Very simply, imagine a world of 100% indexing. How would prices be driven? By indexers, of course. Any price movement would be index-driven.

Indexing Moves Markets -- It is Not "Passive"

Figure 1: LongFin Corp (LFIN)[1]

Figure 1 shows how pricing action does not discriminate between the active or index buyer. Indexing drives prices, and indexing activity, itself, can create market inefficiencies, as shown in the Longfin Corp (LFIN) example.

On February 14, 2018, FTSE Russell announced that it would add Longfin Corp (LFIN) to the Russell 2000 and 3000 indices. The news caused Blackrock and other index trackers to buy nearly half of the freely available float in Longfin, "pushing the shares up from their February low of $32 to above $71," according to the *Financial Times*.

Once FTSE Russell noted they made a mistake, and that Longfin did not meet the 5% free-float requirement to be included in the Russell indices, the stock was removed from the indices after the close March 28, 2018, meaning Blackrock and other index tracking funds, including Vanguard and Charles Schwab, also had to sell their shares at a loss. The idea is not necessarily whether this "mistake" was material to index fund returns, but rather it's important because it shows directly how indexing impacts pricing, causing inefficiencies.

Though this is an extreme example that shows indexing drives prices and that indexing can create inefficiencies, it is no less important of an example, and perhaps its very existence has significant implications. We hypothesize, for example, that, given this empirical evidence, not only can inefficiencies exist in the marketplace, but that some inefficiencies are driven by index investing, itself, and might be explained, in part, as a function of the company's weight in the index, and how many shares are required to be owned by index trackers versus the company's outstanding float. Should the weight of the company in an index cause a large percentage of the float to be purchased by index trackers, there may be greater

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potential for index-driven inefficiencies over an undefined time period.

Figure 2: Explaining Potential Price Inefficiencies Caused By Indexing

$$Index - driven\ inefficiencies = \frac{shares\ purchased\ by\ index\ trackers\ to\ achieve\ index\ weight}{shares\ in\ outstanding\ float}$$

Figure 2 states that the price inefficiencies caused by indexing are, in part, a function of the shares purchased by index trackers to achieve their respective index weightings and the shares in the outstanding float, where there may exist a positive correlation between index-driven inefficiency and the ratio over an undefined time period.

Understanding the Implications of the Arithmetic of Active Management

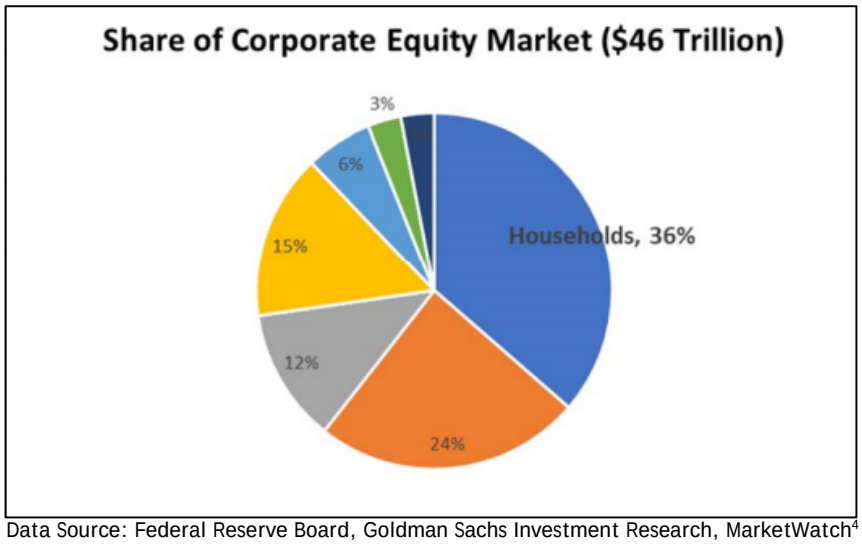
In a source customarily used to support index investing, Nobel laureate William F. Sharpe's work, the Arithmetic of Active Management[2], says that:

> (1) before costs, the return on the average actively managed dollar will equal the return on the average passively managed dollar and
>
> (2) after costs, the return on the average actively managed dollar will be less than the return on the average passively managed dollar.

However, the logic is also very useful in explaining why active stock selection remains very important, too. For starters, if one believes in Sharpe's Arithmetic of Active Management as it relates to the vast $46 trillion corporate equity market, the very idea "whether including or excluding fees…almost all categories of actively managed domestic equity funds underperformed their respective benchmarks on average over intermediate (five years) and long-term investment horizons (10 and 15 years),"[3] means the existence of offsetting outperformance in other segments of the corporate equity market.

Said differently, mutual funds account for just 24% of the corporate equity market (see Figure 3). A large percentage of active funds underperforming (gross of fees) may only imply that other areas, including the largest segment, of the corporate equity market (households at 36%) may not only be outperforming, but also are free of fund fees, altogether.

Figure 3: Households are the Primary Owners of the Corporate Equity Market



Data Source: Federal Reserve Board, Goldman Sachs Investment Research, MarketWatch[4]

Furthermore, the idea that retail investors individually own smaller chunks of the corporate equity market expands upon the definition of Nelson's Syllogism of the Stock Market[5] (please read source work

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for more details), which says that at any time, the number of active investors outperforming can be greater than the number of active investors underperforming, regardless of fees and expenses, each and every year. Said plainly, it's very likely that, if households are outperforming (an offset to active fund underperformance), the number of investors within the household segment may be greater than the number of investors holding underperforming active funds.

Not only do we believe the field of finance cannot conclusively determine the performance of active stock selection on the basis of active fund management alone, which seems to be the primary support for indexing and efficient market theory,[6] but that counterintuitively, active fund underperformance, on a gross basis, may suggest that stock selection outside of both active and *index funds* (and free of fund fees) may be outperforming. If there are more investors in the household segment than in any other segment (and households are outperforming), the field of finance could be using active fund underperformance as a reason to stay away from active stock selection when the opposite may very well be true!

The implications of these findings are vast and may serve to largely bring into question whether individuals and advisors that are actively selecting stocks are truly underperforming, as many are led to believe given active fund underperformance. Not only is stock selection free of fund fees, but it also is free from traditional measures of the investor/advisor behavior gap,[7] which implies further underperformance relative to reported index fund and active fund returns, the latter in most cases already trailing benchmark returns.[8] Can finance really say definitively that active stock selection is underperforming, or is it really just active fund management underperforming, further exacerbated by mutual fund owners, whether individual or advisor, succumbing to a potential behavioral gap themselves?

Is Advisor "Value-Add" A Misnomer?

Another important takeaway of this analysis brings into question whether currently-available research measuring advisor "alpha" is a fair way to present it to the individual mom-and-pop investor. For example, the term "value-add" might generally be viewed as value added above and beyond what might be considered a plain vanilla strategy that can easily be pursued by individuals such as an index ETF that tracks the S&P 500 (SPY) or a diversified and rebalanced stock/bond portfolio benchmark, a rather straightforward strategy. Under a situation, for example, where a financial advisor may pursue a strategy that on a net basis underperforms a reasonable benchmark (as in the case of indexing), but also where a behavioral gap is present, all before the levying of financial advisor fees, themselves, the term "value-add" may simply be inappropriate in usage.

The comparison may be similar, for example, of an active fund manager saying that his or her fund subjectively adds 300 basis points of outperformance because the team talks to management one-on-one, does its own channel checking, and performs extensive due diligence, all good things that "add value." In such a case, it would be hard to argue against that subjective viewpoint, but what if the fund is actually trailing its benchmark by 200 basis points? One wouldn't say the fund is adding 300 basis points of outperformance or net returns? Certainly not. *Under such a presentation, would any active fund be an underperformer*? Does the presentation of "value add" for advisors fall into the same category, given the presence of advisor fees themselves versus plain vanilla advising "benchmarks" and what looks to be documented investor/advisor behavioral gap?

Furthermore, if households, themselves, may be outperforming actively-managed benchmarks, as hypothesized in this paper, what is the appropriate benchmark, for example, to even measure advisor value-add. If the benchmark may be performance relative to a mom-and-pop investor, what if the mom-and-pop investor is actually outperforming, as implied by active fund underperformance? Widely-read opinion, for example, says "advisors can potentially add 'about 3%' in net returns,"[9] but against what reasonable "advising" benchmark--one that assumes individuals are vastly trailing the market and benchmark "advising portfolio" year after year? If most mom-and-pop individuals are not active investment selectors (e.g. households), they may very well be indexing, implying minimal underperformance, at worst. Is the advisor "value add" measured similarly to if an active fund compared its performance to the worst active fund

*Indexing Moves...*continued on next page

***Indexing Moves…*from previous page**

in its respective category? Almost all active funds would outperform in this comparison.

All things considered, this work is not to say that advisors don't help and form a vitally important part of the financial community. Many individuals don't have the time or willingness to deal with their financial lives, and a good financial advisor is there for them. After all, who wouldn't want to spend as much time with the grandkids as possible, while traveling the world? An advisor can offer that flexibility. However, when it comes to the concept of "value-add," the idea is usually referenced against some tangible benchmark based on opportunity cost. From where we stand, opinion that states that advisors "add about 3%" in net returns per year, on average, may not be necessarily appropriate, on the basis of the Arithmetic of Active Management, the existence of an investor/advisor behavioral gap on both index and active funds (advisors hold a large part of the fund universe), and financial advisor fees, themselves.

Conclusion

We think the example of Longfin Corp shows definitively that index investing can move markets and can create inefficiencies. In a prior paper[10], we introduced the concept of expectations "errors" as it relates to testing market efficiency, and in this paper, we strive to identify the foundational element that may help explain not only that inefficiencies exist because of index investing, but also the drivers behind such inefficiencies, illustrated as a function of shares purchased by index trackers to achieve the respective index weight as a percentage of the number of shares in the company's float. It may not be whether indexing moves markets or causes inefficiencies, but rather, how frequently and by how much.

This paper also builds on Nelson's Syllogism of the Stock Market, in cautioning readers who extrapolate underperforming active funds into underperforming overall active stock selection. It remains very likely that on the basis of underperforming active fund returns, that households or another segment of the vast corporate equity market may be outperforming. The idea that the number of outperforming active investors can still be greater than the number of underperforming active investors, regardless of fund performance distributions, is a core dynamic of the Nelson Syllogism of the Stock Market (for funds), but perhaps even more integral when viewing the vast $46 trillion corporate equity market in its entirely.

There is no doubt that advisors are an integral part of the investment community and perform a valuable function of the financial system. However, the term "value-add" in the context of advisories may be a misnomer, as even some of the largest money managers say advisor value is "virtually impossible to quantify (footnote 9, page 2)." We continue to believe that systematic transparency with respect to advisory fees and after-fee advisory returns will only help the individual mom-and-pop investor.

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Biogen Hits a Potential Home Run

We closely follow the progress of the clinical pipeline of companies in the pharma/biotech sector. Unlike other less product-driven industries, the pharma/biotech sector can experience wide swings in operating performance as a result of the lapsing of patent protection on key drugs, underscoring the importance of innovation to replace aging products. Biogen may have hit a home run in the critical field of Alzheimer's, an area of tremendous untapped need.

By Alexander J. Poulos

Key Takeaways

Biogen's current product lineup is beginning to show its age, and a fresh injection of novel products may be necessary to jumpstart top-line revenue growth.

Spinraza is a notable step in the right direction, but we fear new gene-editing therapies may disrupt Spinraza, thus depriving Biogen an avenue of growth.

Biogen is committed to bringing forth a new treatment for Alzheimer's, but the goal of a viable treatment may be elusive. We're optimistic, however. The company reported positive trial results at the 18-month mark on a key Alzheimer's product, but the same compound missed its primary endpoint at the twelve-month mark, raising concerns on how valid the results truly are.

Thanks in large part to the stellar share-price jump driven by the perceived positive data read in Alzheimer's, Biogen has now cut through our $313 fair value estimate to the upside. The company's share price had been under our fair value estimate since August 2015.

Biogen—A Leader in Neuroscience

Biogen (BIIB) is a pioneer in the area of neuroscience with a string of successful treatments, most notably in the area of Multiple Sclerosis (MS). The company's envious position in MS is being eroded, however, as a result of new product entries, including Roche's (RHHBY) Ocrevus that continues to slice into Biogen's once-formidable market share. We have witnessed this phenomenon numerous times; once a key product line begins to witness a credible new entrant into the field (as efficacious or more efficacious), a decline in top-line revenue ensues, directly impacting the future value of the drug.

Often, upon a cursory glance of a low price-to-earnings multiple on a pharma/biotech stock, on its face it may look like a good "bargain," especially versus the average S&P 500 company, but it's more likely the equity may be more akin to a "value trap" as the underlying business may experience a step change downward in earnings in the future due to patent expiration, something that is not "picked up" in current year or even next year's earnings. Investors should cast a cautious eye on multiples in the biotech/pharma sector as the field can undergo "boom-bust" characteristics, if new and revolutionary products are not brought consistently to market to offset the decline in other key products, whether due to a new competitive entry or a patent loss.

Biogen, in our view, may fall closer to the "value trap" definition as the company's main product line--its novel MS franchise--continues to exhibit a deceleration in sales. That is not to say that Biogen's shares don't have value or aren't fairly valued, as they are at the time of this writing; it just suggests its attractive multiple may be a bit misleading (it is trading at ~13 times expected 2019 consensus earnings per share). Further, Biogen's key product Tecfidra posted negative year-over-year US sales performance, the key market for the product. Sales did grow in the rest of the world, but we are beginning to witness signs that overall growth of the MS franchise are beginning to flatten or even decline, which may place undue pressure on new products to succeed, in order to spur top-line growth at Biogen.

Sales of Tysabri, Biogen's second-leading product, continues to lose sales as clinicians, in our view, are shying away from the product due to concerns of PML (Progressive multifocal leukoencephalopathy). PML is often caused in response to the JC virus, a common infection completely unrelated to MS. A healthy immune system may suppress the virus, but in certain MS patients treated with Tysabri, the body is

*Biogen...*continued on page 9

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 July 13, 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	190.96	5.5%-10%
Facebook	FB	0.00%	$250.00	Very Attractive	10	0.83	207.32	5.5%-10%
Alphabet - Class C	GOOG	0.00%	$1322.00	Very Attractive	7	0.90	1188.82	5.5%-10%
Visa	V	0.64%	$130.00	Attractive	6	1.07	139.42	5.5%-10%
Apple Corp.	AAPL	1.56%	$220.00	Highest Rated	6	0.87	191.33	4%-5.5%
SPDR S&P Dividend ETF	SDY	2.34%	NA	NA	UR	NMF	94.54	4%-5.5%
Energy Select SPDR	XLE	2.96%	NA	NA	UR	NMF	76.26	4%-5.5%
Health Care ETF	XLV	1.51%	NA	NA	UR	NMF	87.44	4%-5.5%
Cisco	CSCO	3.05%	$48.00	Very Attractive	3	0.87	41.78	2.5%-4%
Intel	INTC	2.19%	$56.00	Attractive	7	0.93	52.22	2.5%-4%
Johnson & Johnson	JNJ	2.57%	$133.00	Attractive	3	0.95	125.93	2.5%-4%
Altria Group	MO	4.84%	$67.00	Very Attractive	3	0.87	58.50	2.5%-4%
Booking Holdings	BKNG	0.00%	$2104.00	Highest Rated	6	0.97	2031.44	1.5%-2.5%
Chipotle	CMG	0.00%	$453.00	Very Attractive	6	1.01	457.21	1.5%-2.5%
Dollar General	DG	1.24%	$98.00	Attractive	4	1.02	99.50	1.5%-2.5%
Gilead Sciences	GILD	3.17%	$98.00	Very Attractive	3	0.79	77.38	1.5%-2.5%
General Motors	GM	3.45%	$61.00	Attractive	7	0.65	39.36	1.5%-2.5%
PayPal	PYPL	0.00%	$81.00	Attractive	6	1.09	87.99	1.5%-2.5%
Verint Systems	VRNT	0.00%	$54.00	Very Attractive	7	0.90	48.50	1.5%-2.5%
Cash consideration	-	-	-	-	-	-	-	5%-30%

UR = Under Review
This portfolio is not a real money portfolio. Data as of July 13, 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.

Standard Disclaimer: The simulated Best Ideas Newsletter portfolio is for information purposes only and should not be considered a solicitation to buy or sell any security. Valuentum is not responsible for any errors or omissions or for results obtained from the use of the simulated Best Ideas Newsletter portfolio and accepts no liability for how readers may choose to utilize the content.

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unable to keep the virus in check. The JC virus can cause significant and often potentially fatal inflammation of the brain (PML). Biogen has taken great lengths to prevent a flare-up of PML with Tysabri use; however, with newer treatments entering into the marketplace, the risk may not outweigh the rewards, hence the pressure on sales.

Spinraza

The new star in Biogen's product arsenal remains Spinraza, a novel treatment for Spinal Muscular Atrophy (SMA). SMA is classified as a rare genetic disorder that affects the motor neurons found in the spinal cord. The disease prevents the neurons from sending signals to the muscles hence preventing movement; as muscles are not utilized, they atrophy (become smaller) from lack of use. Spinraza gained US FDA approval in December of 2016, thus providing those afflicted with SMA a viable treatment.

Spinraza posted an impressive debut in 2017, generating sales of $884 million in 2017 as the product was quickly utilized by the SMA community. SMA is a rich target area of perhaps the hottest trend in biotech today—gene modification therapies with Novartis (NVS) making a large splash in the field with the audacious takeout of AveXis to gain control of its industry-leading AAV9 vector therapy.

Conceptually, we like the practicality of gene-modification therapy. If the therapy lives up to its promise, the potential for a "one and done" course of therapy would hold great appeal to both payers and patients alike. Currently, however, we have witnessed a decline in the effectiveness of the product as time progresses, most notably in the hemophilia treatments. We are reserving judgment of the overall potential of gene therapies at this time until longer-term data is generated and presented, but from where we stand, the promise of Spinraza is under credible threat from a deep-pocketed rival that is well-versed in the MS field, thus adding credence for the potential total disruption of the promise of Spinraza.

Growing Biosimilar Pipeline

We remain big fans of the promise of biosimilars, as the coming wave of biosimilars promises to dramatically reduce the cost of the specialty drug spend, most dramatically in the US. Specialty drug spend is the primary growth engine in the pharma sector with year-over-year growth often lapsing the growth witnessed in traditional oral therapies such as tablets and capsules. The difference in pricing centers on the lack of competition due to a cohesive set of laws governing the use of biosimilar products. The industry, however, may have entered a new age of enlightenment on the part of the FDA with a robust platform to ease the transition towards opening up price competition.

Biogen in conjunction with its partner Samsung Bioepsis has skillfully entered the worldwide market for biosimilars with a viable alternative to Enbrel, which remains Amgen's (AMGN) top-selling product (original approval in November 1998 which highlights the lack of innovation from Amgen) and Remicade. The joint venture generated $380 million in sales in 2017, but we expect the number to jump substantially beginning in October 2018 when the duo will be allowed to market a biosimilar version of Humira in Europe called Imraldi. Humira remains AbbVie's (ABBV) top-selling product accounting for over 50% of the group's overall revenue.

We fully expect the EU to embrace Imraldi, which will help lower overall costs while reducing Humira's growth trajectory. Humira generated over $6 billion in international sales in 2017 with the vast majority of sales emanating from the EU, underscoring the large potential market for a biosimilar for Humira. We feel the biosimilar division will become a source of revenue growth for Biogen over the next few years as the promise of the biosimilar market comes to fruition. For Biogen to morph more into more into a growth entity, additional productivity from the near term pipeline will be needed.

The Promise of Alzheimer's

The primary area of intense R&D spend for Biogen remains the ever-elusive goal of a viable treatment for Alzheimer's disease. Alzheimer's is a progressive loss of memory which typically afflicts those in the sixth

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decade of life. With the rapid greying of America, we fully anticipate the number of patients diagnosed with Alzheimer's will explode over the next few decades surpassing the current estimate of over 3 million afflicted patients.

Alzheimer's is the sixth leading cause of death with the average patient lasting eight years after symptoms become noticeable. The current crop of treatments is deemed inferior, thus underscoring the critical need for further innovation in this sector. There have been numerous spectacular flameouts as the goal of a viable treatment remains elusive. The share price of Biogen slumped once early results of BAN2401 were released in December as the product missed its primary endpoint at the twelve-month mark. Biogen and its commercial partner Eisai decided to forge ahead with the trial collecting data up until the eighteen-month mark to determine if the therapy offers any hope.

On July 5, Biogen issued a press release stating BAN2401 showed a statistically significant reduction in slowing the Alzheimer's Disease Composite Score, a key indicator of disease activity. The announcement came as a great surprise as the product was virtually written off six months ago when it failed its initial clinical trial. Biogen did not reveal the entirety of the data set underscoring just how difficult it will be to handicap the commercial viability of the product. The share price of Biogen jumped ~15% upon the recent data release, underscoring the critical importance a new line of therapy is for Biogen.

Concluding Thoughts

We remain optimistic on the prospects of Biogen as we view the company as attractive, but inherently risky as the next leg of growth will be entirely dependent on an Alzheimer's therapy with a spotty clinical track record. We feel the wide fair value range of $219-$407 underscores just how risky we view the equity at its current quote. Thanks in large part to the stellar share-price jump driven by the perceived positive data read in Alzheimer's, Biogen has now cut through our $313 fair value estimate to the upside. The company's share price had been under our fair value estimate since August 2015.

Restaurant Traffic Down, Chipotle Still a Favorite Idea

By Brian Nelson, CFA

We like Chipotle (CMG) for three primary reasons: 1) in CEO Brian Niccol, the company has a new bold visionary at the helm and he is hiring top talent to fill gaps, 2) buyouts in the restaurant space will only offer support for shares as the fast-casual segment remains a key focus area for private equity (here and here), and 3) Chipotle has been plagued with so many health issues ("foodborne illnesses") in the past that, even with the recent bounce in shares, the market's expectations are still rather low. Though our fair value estimate of Chipotle does not reflect a surge in expected same-store-sales performance or the launch into the breakfast daypart, we like the refreshed executive team that has innovation running in its blood, and we think it will be able to position the company effectively over the long haul.

It's been a while since there's been bad news at the burrito-making giant, and as we've seen with past food sourcing issues at Yum! Brands (YUM) and McDonald's (MCD) in China, consumers are either forgiving or forget, and that means they often come back. We don't think Chipotle has alienated its core customer base, and we think the lull in bad news may be a good thing once momentum starts to return to same-store sales. The game at Chipotle will be one of share capture, and we think menu innovation will be key. For example, comparable store traffic across the restaurant space fell 2.9% during the month of May, according to data from TDn2K, a further deceleration from the -2.1% rolling 3-month average. Chipotle's New York test kitchen has been very active in coming up with new menu items (Quesadilla, Avocado Tostada, Mexican Chocolate Shake).

The company's first-quarter 2018 results, released in late April, showcased 7.4% revenue growth, comparable store-sales increases of 2.2%, restaurant operating-margin improvement of 180 basis points,

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and considerable net income and diluted earnings-per-share expansion. For the full year, Chipotle expects comparable restaurant sales to advance in the low-single-digits and for new restaurant openings to be in the 130-150 range. Chipotle looks well on its way to a healthy recovery. The high end of our fair value estimate is nearly $600.

Twitter Working Backwards?

The social media platform known for its tweets faced selling pressure after reports surfaced that it had removed 70 million fake accounts from its website. Social media is still a relatively young technology, and our top idea in the space remains the cash-rich Facebook.

By Kris Rosemann

Shares of Twitter (TWTR) fell more than 5% during the trading session July 9, less severe than the drop had been at its session worst, following a report from The Washington Post outlining the company's suspension of 70 million fake or spam accounts in the months of May and June. Twitter had 336 million monthly active users as of the end of the first quarter of 2018, but company officials have been adamant that most of the accounts removed had not been active on the platform for 30 days or more, or are caught at sign up, suggesting monthly active user growth data would not be impacted.

Nevertheless, the 5%+ drop in Twitter's shares July 9 seems to have raised concerns about the quality of Twitter's published monthly active user numbers, despite management's reassurance to the contrary. It may be close to impossible to determine whether a meaningful percentage of accounts still in Twitter's numbers are real or not. As programmers become more and more sophisticated in generating bots and accounts, many are growing worried that Twitter may not be as large as the published number suggest.

The most important sticking point from the Washington Post piece is the matter of how this will impact monthly active user growth for Twitter, a figure for which it has drawn material criticism as it has struggled mightily to keep pace with social media big brother Facebook (FB) in the recent past. Without evidence to the contrary, company officials are the most reputable source for information on whether or not the deleted or suspended accounts will impact its reported user growth in its upcoming quarterly report July 27. This may have important implications on how much companies are willing to spend if the number of Twitter users is much smaller than originally believed.

The questions regarding user growth are not solely tied to this recent round of removals either. Concerns about the direction in which Twitter takes the policy of suspending fake or spam accounts, which can also include those run by real people but act maliciously towards others, may have been flamed by Del Harvey, Twitter's vice president for trust and safety, saying that the company is changing the way it is differentiating between promoting public discourse and preserving safety. Her comment that the company has only recently been able to dedicate the resources to such a task highlights the fragile nature of its profitability.

Twitter had previously stated that 5% of its active user base consists of fake accounts or engage in spam, and that less than 8.5% use automation software, characterizing them as "bots." Though very difficult to prove, this may be harder for investors to believe after the news of 70 million accounts being removed in two months hit the wire. The number of users on Twitter's platform that can be reached by company advertisements remain its key selling point and core revenue driver, so removing 70 million accounts is a rather big deal to its revenue model, even if strengthening its core user base may not be a bad thing, in itself.

Policing its user base does not come without cost for Twitter either. Not only can it potentially create disappointing and market-moving headlines for investors and the corresponding related share-price weakness--and any perceived "misstep" may very well be hyper-examined in the ultra-politicized environment in which we live--but the company must deal with the explicit costs of having to monitor

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actions by its user base. As Del Harvey noted, Twitter has only recently been able to dedicate resources and develop the technology to go after malicious behavior in such an aggressive manner, and those resources may have had a higher ROI if deployed elsewhere.

Whether or not Twitter's more aggressive stance on fake and spam accounts will prove to be prudent will not likely play out for some time, but what matters is that it gives investors another reason for pause before considering the idea. Social media platforms carry unique risks as they are increasingly found at the center of human interaction (for the most part, anyway), and the responsibilities of the platforms are being sorted out in real time right before our eyes. It may be common knowledge, for example, that Twitter is a great way to spread news, but it unfortunately is an even easier and faster way for fake news to spread, too.

The additional risk in public and political pressures that may add to costs, but shut out new entrants as well, may be yet another reason why we prefer Facebook over Twitter in the social media space. Facebook's fortress-like balance sheet ($44 billion in cash and no debt on the books at the end of the first quarter of 2018) provides it with tremendous flexibility, and while Twitter has been free cash flow positive for multiple years, it can't hold a candle to the free cash flow generating capacity of Facebook. For comparison, Twitter turned in $670 million in free cash flow in 2017 (~27.4% of revenue), while Facebook reported nearly $17.5 billion in free cash flow in 2017 (~43% of revenue).

Facebook does carry many of the same risks as Twitter when it comes to managing its population of users, and as we witnessed with the Cambridge Analytica scandal, shares of Facebook are certainly not immune to public relations issues. Social media is still a relatively young technology, and there can be no guarantee as to what the landscape might look like five or ten years from now. However, we're sticking with the platform that continues to turn in robust user and revenue growth and has impressive levels of profitability in addition to the cash flow and balance sheet characteristics listed above. That same platform recently registered a 10 on the Valuentum Buying Index! That's Facebook!

Internet Sales Taxes and Restructuring the U.S. Post Office

The Supreme Court has been active in creating revenue opportunities for states, as in legalizing sports betting and most recently in facilitating the collection of online sales taxes. The White House has floated the idea of reorganizing the U.S. Postal Service, but we think this endeavor represents more of a tail risk for Stamps.com than anything else. Though we expect smaller online retailers to feel some pressure as a result of the online sales tax ruling (Amazon already collects online sales taxes), we don't think the ruling, while leveling the playing field for some brick-and-mortar retailers, will change the fate of many aging department stores such as J.C. Penney and Sears, both of which may not make it to the other side of the next downturn with shareholder capital intact.

By Brian Nelson, CFA

What has been a boon for expected earnings and free cash flow generation from the recently-implemented corporate tax cuts may in part be offset at some smaller online retailers by a recent Supreme Court ruling that overturned a 26-year-old precedent that said businesses that didn't have a "physical presence" in a state need not collect sales taxes there. The 5-4 ruling issued June 21 (see here) against Wayfair (W), Overstock (OSTK), and online retailer Newegg, specifically, may indicate that Internet retailers may eventually lose one of their biggest cost-advantages against brick-and-mortar rivals. Though we view this as a landmark ruling, we're not making any changes to the fair value estimates of companies in our coverage at this time.

For starters, we think some of the relatively smaller online retailers lacking significant scale may likely be hurt the most. On the other hand, we're not expecting much in the way of an impact at Amazon (AMZN) or eBay (EBAY), which have greater means to extract cost synergies across their operations and drive retention (free shipping, Prime Video) more so than smaller players. Amazon, for example, has

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already been collecting sales taxes across the country since April 2017. We also think the Supreme Court ruling helps the brick-and-mortar retailers, especially in creating a more level-playing field with respect to their online initiatives. The ruling may also serve to stymie potential new entrants from leaping into the e-commerce arena due to the higher tax bill, which raises the price of their products to consumers.

That said, we don't think the consumption pattern by consumers will be altered due to online sales tax collection, as the value of convenience is something that cannot be underestimated. Said differently, we doubt consumers are going to pursue a wholesale change with their buying patterns because of a 5-10 percentage point increase in the bill from sales taxes. Remember, Amazon is already collecting sales tax, too, so there won't be much of a catalyst at the top, per se. Likewise, the impact on payment processor PayPal (PYPL) and the credit-card networks such as Visa (V) and Mastercard (MA), for example, may be muted. E-commerce proliferation is here to stay, and we don't see much that will derail the rapid pace of digital expansion anytime soon.

As with the recent ruling to legalize sports betting, we think the Supreme Court decision supporting the collection of online sales taxes will only help state tax coffers, perhaps lessening the burden on federal support, which may be hampered considerably as a result of capital-expensing provisions and the vastly reduced rate within the new corporate tax code. In some ways, investors may want to see higher taxes on the state level, as it may reduce sovereign credit risk and the ongoing pace of the rise in interest rates (SHV, SHY, IEF, IEI), which have been pronounced in recent months. Though a restructuring of the U.S. Postal Service, "including the possible privatization of mail delivery" may impact delivery and shipping logistics at some online retailers, such a proposal represents, in our view, more of a tail risk for Stamps.com (STMP) than a massive headache at the online retailers.

All in, we're viewing developments with respect to online sales tax collection and the possible restructuring of the U.S. Postal Service as relatively non-events, but perhaps generating material risk for Stamps.com. We still don't like department-store retail, namely J.C. Penney (JCP) and Sears (SHLD), and we believe these two in the group may not make it to the other side of the next recession without wiping shareholders clean. The political and regulatory landscape will always be in flux, and we're not doing much with our fair value estimates as a result of the news. We may seek to widen our fair value estimate range on Stamps.com, however, but we already feel shares have run up too fast.

PayPal Hits New Highs!

We continue to watch PayPal as it has been a fantastic idea in the simulated Best Ideas Newsletter portfolio since it split from eBay. Rivalries are intensifying in the digital payments space and the company will have to replace lost business with eBay in coming years, but we still like the idea. We also view Bitcoin and other cryptocurrencies as more an opportunity than a threat for many digital payment providers.

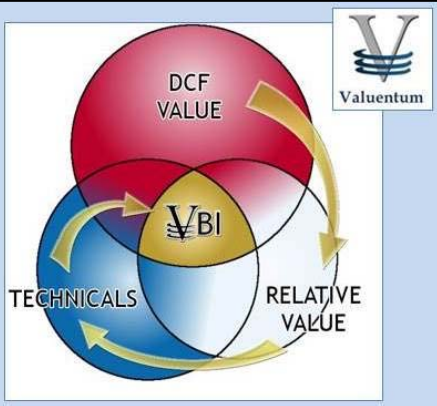
By Brian Nelson, CFA

On June 19, PayPal (PYPL) announced it would acquire Hyperwallet for $400 million in cash. We think the PayPal executive team was impressed with the technology at Hyperwallet, which faciliates the ability to "pay almost anyone almost anywhere in the world." As PayPal fuses this technology with its own, we think PayPal only increases its value-add to merchants and consumers in providing an integrated end-to-end solution. The addition of new offerings/technologies to the PayPal platform will be vital as rivalries are intensifying, perhaps no better illustrated than with Dutch payments company, Adyen.

What draws us strongly to PayPal is its pace of growth and its tremendous free cash flow generation and balance-sheet health. As has been the case with Square (SQ), we think the evolution of cryptocurrencies such as Bitcoin (BTC, GBTC, COIN) within the global financial system will only provide further growth opportunities for PayPal. Braintree, which is a part of PayPal, had partnered with Coinbase nearly four years ago to accept Bitcoin payments, and we think PayPal is well-positioned to capitalize on increased cryptocurrency adoption. As with the digital payments industry, in general, it is vast enough for a great many number of winners, and we think PayPal will be one of them. The high end of our fair value estimate of PayPal is near-$100 per share.

What Are the Qualities of Highly-Rated Stocks on the Valuentum Buying Index?

By Brian Nelson, CFA



"Does a CEO have any control over his or her company's Valuentum Buying Index rating? The short answer is no. A CEO can impact a great many things about his/her company, but he or she has little control over 1) the price-to-fair value ratio, 2) how companies are priced relative to his or her own company, and 3) whether institutional investors will interpret its stock as underpriced and begin to scoop up shares to cause price-to-fair value convergence. The CEO is focused on driving business fundamentals, but the investor is focused on capitalizing on asset mispricings and/or achieving income growth goals." -- Brian Nelson, CFA

If you were a CEO, what are the 7 most important metrics to focus on to get a rating of 10 on the Valuentum Buying Index?

This is a great question because it hits at the absolute heart of the most important concept of investing. Investing may be about buying a great company with a solid and growing dividend, but it *most certainly* is about buying a great company at a *discount to intrinsic value*. The difference between what someone can pay for something and what something is worth is the most important concept of investing: price versus value. The price-versus-value component is an integral part of the Valuentum Buying Index. In fact, it is the first component. After all, price is what you pay for something; value is what you get.

But a robust discounted cash-flow analysis to derive an intrinsic value estimate for a company is only the beginning. There are myriad benefits to using discounted cash-flow analysis, including deriving a fair value estimate for a company on the basis of the company's unique characteristics, but the outcome of the discounted cash-flow process is still sensitive to a large number of inputs, not the least of which is the discount rate applied to those future free cash flow streams. That's why we look at a range of fair value outcomes (the fair value range) before determining whether a company's shares are undervalued or overvalued. A fair value estimate is just the most likely fair value, not the "true" intrinsic value. Because all value is based on the future and the future is inherently unpredictable, *nobody* knows the true intrinsic value of a company. That doesn't mean the discounted cash-flow process isn't extremely valuable -- it just means that the outliers -- those that fall outside the fair value range -- are the most meaningful considerations.

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To address some of the perceived pitfalls related to the discounted cash-flow process, we perform an extensive relative valuation assessment based on future expectations of a company and its closest peers or competitors. Some companies don't have the best peer comparisons, but no company is exactly the same, in all cases. Much like the discounted cash-flow process, however, we're less concerned about precision than we are about identifying valuation outliers. In the relative valuation process, we compare the forward P/E ratio and the forward 5-year PEG ratio (all derived in-house) to those of a company's competitors and peers. If both measures are attractive, we'd consider the company undervalued from a relative valuation standpoint. If both measures are unattractive, we'd consider the firm overvalued from a relative valuation standpoint. We want to be approximately right than precisely wrong. Precision in valuation, and investing, is unattainable.

Identifying stocks that are trading at a large discount to a discounted cash-flow-based intrinsic value estimate and versus peers is only part of investing, however. Eventually we want those stocks to converge to our estimate of their intrinsic value -- and in order for a stock to converge to intrinsic value, other investors must purchase that stock, driving its stock price higher. This represents the basic building blocks of any market. When large institutional investors start purchasing a company's stock, it takes time for them to fill their entire positions. Therefore, underpriced stocks that are being purchased by institutional buyers will tend to continue to exhibit strong price momentum for some time into the future. This increases the likelihood of what we describe as price-to-fair value convergence. A stock that is undervalued both on a discounted cash-flow basis and relative valuation basis and has just started to exhibit strong technical and momentum indicators scores high on the Valuentum Buying Index.

So, with this knowledge, does a CEO have any control over his or her company's Valuentum Buying Index rating? The short answer is no. A CEO can impact a great many things about his/her company, but he or she has little control over 1) the price-to-fair value ratio, 2) how companies are priced relative to his or her own company, and 3) whether institutional investors will interpret its stock as underpriced and begin to scoop up shares to cause price-to-fair value convergence. The CEO is focused on driving business fundamentals, but the investor is focused on capitalizing on asset mispricings and/or achieving income growth goals. However, there are several things a CEO can do to put his company in the best position to achieve the highest rating on the index. Let's dig into 7 of them.

1) A focus on free cash flow. Free cash flow, as measured by cash flow from operations less all capital spending, is the primary building block of the valuation equation, and companies that generate gobs of free cash flow tend to offer investors opportunities as most market observers tend to mostly be satisfied with just looking at accounting earnings per share (EPS). Improving working capital turns (faster collections, reduced inventory), driving better levels of profitability (higher EBIT margins), and finding more efficient ways to invest capital (reducing capital spending on low-return projects) are three areas in which free cash flow can be bolstered. The best cash-flow generators will be those with high-EBIT-margin, asset-light operations such as software firms Adobe (ADBE) or Microsoft (MSFT) or online based entities such as Booking Holdings (BKNG), formerly Priceline.

2) A healthy balance sheet. The net cash, total cash less total debt, on a company's balance sheet is a key component of the valuation equation. The net cash on the balance sheet is to a company as the cash in your personal savings account is to you. There's potentially a lot of value there. But most of the market may only be looking at the income statement, as many could be most interested in evaluating earnings per share for the next quarter, for example. Valuation mispricings often occur because investors aren't paying enough attention to the balance sheet, in our view. Cisco (CSCO) and Apple (AAPL) have two of the most net-cash-rich balance sheets on the market today.

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3) Monetize hidden assets. Again, the market doesn't spend too much time digging into a company's regulatory filings to uncover hidden assets. For example, Altria (MO) recently presented a fantastic opportunity because of its hidden investment in SABMiller (SBMRY). Yahoo (YHOO) had one of its best stock-price runs in history during the past few years because of its hidden investment in Alibaba (BABA). Graham Holdings (GHC), formerly the Washington Post, has a pension fund that is ~$1.2 billion overfunded. These are assets that the market misses when they just focus on the income statement, or on earnings per share.

4) A focus on return on invested capital (ROIC). If a CEO's compensation is still being tied to EPS performance, the company may be setting itself up for disappointment. A look at the incentive structure behind the compensation of IBM's (IBM) executive suite, for example, may have explained why management had a formal operating EPS target. The operating EPS target led the company to buy overpriced stock to meet short-term EPS targets, and perhaps dull its focus on improving operating performance. IBM has suffered as a result. We think all CEOs should be incentivized primarily or in part on the basis of some internal measure of return on invested capital (ROIC). The companies with the highest returns on invested capital will have the highest-rated Economic Castles. A few of these companies are Domino's Pizza (DPZ), Morningstar (MORN), Oracle (ORCL), and Raytheon (RTN).

5) Target growth markets. In order to score well relative to peers in any forward-looking PEG assessment, a company must be growing the bottom-line. A CEO that is targeting growth with high-ROIC projects is going to generate significant free cash flow generation while adding value to the organization. On the other hand, the likelihood of companies heading to obscurity (and their stocks heading to $0) is exponentially increased when revenue and earnings are falling. These firms can only add value via cost-cutting, and cost-cutting is a finite exercise. Eventually, they reach the bone. Blackberry (BBRY) and Radio Shack (RSH) are two examples of companies where revenue has faced material pressure. On the other hand, Facebook (FB) and Alphabet (GOOGL) are two fast-growing companies that are generating significant economic profit (ROIC-less-WACC) for shareholders.

6) A healthy and growing dividend. This focus may seem like a surprise, given that the Valuentum Buying Index measures only the capacity for wealth creation (capital appreciation). In fact, there is no explicit lever within the Valuentum Buying Index that considers the dividend because, as investors, we're interested in the entire free cash flow stream, not only the portion paid out as dividends. Recent studies, however, have indicated that some of the best-performing stocks over time have been dividend initiators and dividend growers. In the current market environment, this outperformance has held true, and many dividend growth stocks have been exhibiting fantastic stock pricing momentum. A focus on the Dividend Cushion ratio not only ensures better capital discipline (higher ROIC) by management, but it also indicates that there is ample future expected free cash flow generating capacity and excess capital on the balance sheet to keep the dividend growing into the future. Some companies with lofty dividend yields and high Dividend Cushion ratios include Johnson & Johnson (JNJ) and Hasbro (HAS).

7) Exhibit the highest ethical standards. There's nothing more controversial (and risky) than businesses that have questionable business models. If there's a company that we're not comfortable doing business with ourselves, we won't rank it high on the index. Stocks such as Valeant Pharma (VRX) have never registered high on the Valuentum Buying Index rating system. We'll never be insiders at a company, so we have to come to trust management and what they say. If there are companies that violate our trust, we can't afford to put our reputation on the line with them. All we have is your trust, and we won't do anything to jeopardize that.

Did you find this article helpful? Let us know.

A version of this article appeared on our website November 23, 2014. Updated July 11, 2018.

Excerpts From The 16 Most Important Steps To Understand The Stock Market

By Valuentum Analysts

A previous version of this article appeared on our website July 21, 2013. For the full article visit: https://www.valuentum.com/articles/20130225_2

1) The Stock Market Is a Market. Let's start with the very obvious. The stock market is driven by the actions of people. People are imperfect. People make mistakes. People have biases. Some people are greedy; some people are fearful. I think when individuals first start to invest, they believe that the stock market is orderly, calculated -- that it may be as precise as accounting, as in assets equal liabilities plus owners equity, for example. In other words, new investors think that if a company does well fundamentally, then its stock should do well, too. Unfortunately, the stock market is often nothing like this, and even good, "moaty," competitively-advantaged companies with strong brand names can make for bad stocks, if bought at the wrong price.

Key takeaway: The stock market is neither rational nor precise, and it is driven by the buy and sell decisions of participants (including your doctor, lawyer, shoe-shiner, and yes, even your taxi cab driver-or should I say, limo driver). But it is also because of this dynamic that opportunities in the market exist!

4) Everything in the Stock Market Is a Self-Fulfilling Prophecy. I hope you're still with me because this step is so very important. I cannot tell you how many times I have heard that technical analysis (chart reading) is a self-fulfilling prophecy because it is driven by the actions of buyers and sellers reacting to or anticipating patterns in a chart. Those same individuals then claim that value investing or growth investing is not a self-fulfilling prophecy. Once I hear that, I know that most value investors haven't read Step 1 above. If you have, you already know more about the market than they do.

7a) Dividends Are a Symptom, Not a Driver of Intrinsic Value

Dividends are a symptom of value, not a driver of intrinsic value. The intrinsic value of a company is generally based on a company's net cash position on the balance sheet and what it generates in future free cash flows, discounted back to today. All other qualitative factors (management, strategy, new products, and the like) must translate into future income/cash flows to have any monetary intrinsic value.

Because a company pays a dividend out of free cash flows (or net cash on the books) and not from earnings per share (which is an accounting measure, not a cash measure), the dividend is an output to the valuation of the company (it is a symptom), not a driver behind it. To hit this point home, for example -- there are many companies that could be considered fantastic investments that pay no dividends at all. Warren Buffett's Berkshire Hathaway (BRK.B) is perhaps the best example. It has never paid a dividend.

9) Value Is a Range and Not a Point Estimate. I can't begin to tell you how surprising it is to hear even well-seasoned analysts say a company's shares are worth precisely $25 each 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 probably worth somewhere between $75 and $125. Value is not a precise point estimate, but a range of probable outcomes. 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).

Any investor that says a stock is worth a precise figure--whether it's $1 or $100--doesn't understand one of the most important factors behind valuation. *Key takeaway: The value of a company is a range of probable outcomes based on its future free cash flow stream. Value is not a precise point estimate.*

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11) Growth Is a Component of Value. Unfortunately, the mutual fund industry (and now the proliferation of factor-based investing and ETF creation) has confused just about everyone with respect to this concept. There are really not growth stocks and value stocks. There are either undervalued stocks, fairly valued stocks, or overvalued stocks. Growth is a component of value.

For example, Alphabet (GOOG, GOOGL), formerly Google, which is growing fast, can be undervalued, while a company with a single-digit P/E can be overvalued. Though we know this is an ambitious statement, every analyst and investor should build a complete discounted cash flow model at least once in their life to see how growth fits into a value assessment. We'd be happy to help. We make available a discounted cash-flow modeling tool on our website. We think there is no better way to learn this important concept that Buffett has been known to utter a time or two. *Key takeaway: There are really not growth stocks and value stocks. There are either undervalued stocks, fairly valued stocks, or overvalued stocks.*

15) Value and Momentum Outperform Everywhere. Momentum is the biggest embarrassment to efficient markets (according to Eugene F. Fama, the "father of modern finance" and Nobel laureate), quantitative academic research continues to conclude that 'Value and Momentum' combined outperform in every market across every asset class, and we continue to demonstrate the strength of a combined value-momentum process *within* stocks in the portfolio of the simulated Best Ideas Newsletter and Nelson Exclusive publication. See our Learning Center. The Valuentum process is not quantitative, per se, as it is fundamentally-based, and the Valuentum methodology seeks to combine forward-looking intrinsic value and relative value ("behavioral valuation (pdf)") with technical and momentum indicators within stocks.

16) Keynes Was Right. I remember reading Keynes' work years ago, *The General Theory of Employment, Interest and Money*, and at that time, it never really resonated with me. But after reading just about everything I could get my hands on, spending years and years in school, and training analysts in both equity and credit research, I believe Keynes was one of the most brilliant thinkers in the modern era. This step isn't about his economic policies that you've read about in economic textbooks, but it's about how he thought about the stock market.

Keynes compared the stock market to a beauty contest. He said that to pick winning stocks, investors need to pick the contestant (stock) that they think other judges (money managers) like, not the contestant that they like. This is absolutely genius, in my view, not only because it is true but because he put this into text decades ago (1936)! The secret to successful stock selection, in my view, is to have an understanding of many investment disciplines to aid in finding the "best" stocks at the "best" time to consider buying (Valuentum investing). After all, investors need other investors to eventually agree with them for their stock calls to work out (see Steps 3 and 4), and this requires a deep understanding of which stocks they may put their money into in the future.

This, of course, doesn't mean the methodology attempts to "front-run" others -- but it does mean we do extensive discounted cash-flow analysis to derive an intrinsic value assessment, an extensive relative value assessment to understand what many traditional investors are thinking, and a technical momentum assessment to help identify where the fast-money may be looking to allocate capital. The Valuentum strategy is a process with considerable checks-and-balances that is focused on identifying winning ideas, and it has worked wonderfully thus far. *Key takeaway: The "best" stocks, in our view, are those that are undervalued and are just starting to exhibit strong momentum qualities, revealing the greatest likelihood of price to fair value convergence. Said differently, we like underpriced stocks that are just starting to go up.*

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

NEWSLETTER EDITORS

BRIAN NELSON, CFA
Started career in 2004 | Founded Valuentum in 2011

Mr. Nelson received a Bachelor of Business Administration from Benedictine University and an MBA with concentrations in Finance and Accounting from the University of Chicago Booth School of Business. He is a CFA charterholder.

KRIS ROSEMANN
Started career in 2015 | Joined Valuentum in 2015

Mr. Rosemann received a Bachelor of Science in Applied Mathematics from Benedictine University, minor in Finance. He is a CFA Level II candidate.

The information in this document is for informational purposes only and should not be considered a solicitation to buy or sell any security. The Best ideas Newsletter is a monthly publication and the simulated portfolio within it is not an investable fund. The calculations and information herein are provided by Valuentum and have not been externally audited. Every effort has been made to ensure accuracy, but no guarantees regarding any data or calculations can be made. Past results are not a guarantee of future performance, and actual results may differ from simulated information provided. Investing comes with risk of capital loss. Please see back page for the full disclaimer.

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%

NOT A FUND | SIMULATED INFORMATION | NEWSLETTER PUBLISHER

Cisco (CSCO) – Page 1 of 16

Download Cisco'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 28-May-2018 — Data as of 18-May-2018

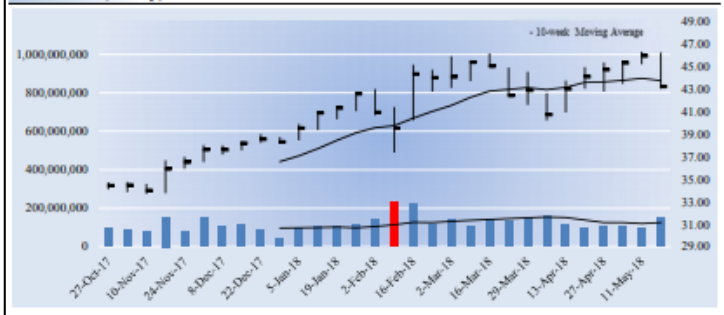
Cisco CSCO FAIRLY VALUED

Buying Index™ 3 — Value Rating

Economic Castle	Estimated Fair Value	Fair Value Range	Investment Style	Sector	Industry
Very Attractive	$48.00	$38.00 - $58.00	MEGA-CAP VALUE	Information Technology	Networking Equipment

Cisco's free cash flow generating capacity and balance sheet strength is tremendous give reason for confidence despite a lower-growth outlook in the near term.

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	NEUTRAL
ValueCreation™	EXCELLENT
ValueRisk™	LOW
ValueTrend™	POSITIVE
Cash Flow Generation	STRONG
Financial Leverage	MEDIUM
Growth	MODEST
Technical Evaluation	VERY BEARISH
Relative Strength	NEUTRAL
Money Flow Index (MFI)	NEUTRAL
Upside/Downside Volume (U/D)	DETERIORATING
Near-term Technical Resistance, 10-wk MA	44.00

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)	$218,167
Avg Weekly Vol (30 wks)	119,997
30-week Range (USD)	33.67 - 46.37
Valuentum Sector	Information Technology
5-week Return	0.2%
13-week Return	-1.8%
30-week Return	25.4%
Dividend Yield %	3.1%
Dividends per Share	1.32
Forward Dividend Payout Ratio	50.7%
Est. Normal Diluted EPS	2.96
P/E on Est. Normal Diluted EPS	14.6
Est. Normal EBITDA	19,956
Forward EV/EBITDA	9.9
EV/Est. Normal EBITDA	9.1
Forward Revenue Growth (5-yr)	2.9%
Forward EPS Growth (5-yr)	11.1%

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

Investment Highlights

• Cisco sells Internet Protocol based networking and other products related to the communications and IT industry. The firm provides a broad line of products for transporting data, voice, and video. It is #1 or #2 across a wide variety of architectures, and we like the progress it is making in its transition to a software and subscription based business model. It was founded in 1984 and is headquartered in California.

• Cisco has been acquisitive as of late. Instead of targeting suppliers to improve its gross margin, the firm's M&A strategy will be focused on disruptive technology and software and cloud acquisitions that will positively impact gross margins.

• We like that Cisco is aggressively buying back stock. In fact, the firm intends to return a minimum of 50% of annual free cash flow to shareholders via dividends and buybacks. Since its share repurchase program began through July 2017, the firm has repurchased roughly $100 billion in shares, and has nearly $12 billion remaining authorized for share repurchases.

• Future revenue growth at Cisco is now expected to be in the range of 1%-3% during the next 3-5 years. This is down from 5%-7% annual growth expectations it set during its conference in 2011 and a more recent target of 3%-6%. The firm must continue to adapt to evolving markets and meet the changing demands of customers.

• Cisco had an incredible $54+ billion in cash and cash equivalents at the end of the third quarter of fiscal 2018. Such a cash hoard gives it tremendous financial flexibility to pursue value-creating acquisitions and/or significantly increase the dividend.

Relative Valuation

	Forward P/E	PEG	Price / FV
Finisar	17.6	NMF	75.3%
Juniper Networks	14.4	1.4	83.3%
Knowles Corp	15.9	2.7	95.5%
Nokia	21.9	NMF	88.6%
Peer Median	16.8	2.0	85.9%
Cisco	**16.6**	**2.1**	**90.0%**

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

Returns Summary — 3-year Historical Average

Return on Equity	15.9%
Return on Assets	8.3%
ROIC, with goodwill	27.4%
ROIC, without goodwill	64.7%

ROIC = Return on Invested Capital; NMF = Not Meaningful

Leverage, Coverage, and Liquidity

In Millions of USD

Total Debt	33,717
Net Debt	-36,775
Total Debt/EBITDA	2.2
Net Debt/EBITDA	NMF
EBITDA/Interest	17.4
Current Ratio	3.0
Quick Ratio	2.9

NMF = Not Meaningful

Financial Summary

	----- Actual -----		Projected
Fiscal Year End:	Jul-16	Jul-17	Jul-18
Revenue	49,247	48,005	49,157
Revenue, YoY%	0.2%	-2.5%	2.4%
Operating Income	12,928	12,729	15,930
Operating Margin %	26.3%	26.5%	32.4%
Net Income	10,739	9,609	12,962
Net Income Margin %	21.8%	20.0%	26.4%
Diluted EPS	2.11	1.90	2.61
Diluted EPS, YoY %	20.9%	-9.8%	36.9%
Free Cash Flow (CFO-capex)	12,424	12,912	14,060
Free Cash Flow Margin %	25.2%	26.9%	28.6%

In Millions of USD (except for per share items)

Structure of the Networking Equipment Industry — POOR

Firms in the networking equipment industry provide products for transporting data, voice, and video within businesses and around the world. Participants must adapt to address virtualization/cloud-driven needs in the enterprise data center market; the convergence of video, collaboration, and networked mobility technologies; and the move toward programmable, virtual networks. The industry is characterized by low barriers to entry, rapid technological change and significant pricing competition. Gross margins can be volatile and should be watched closely. We don't like the structure of the group.

The information and data contained in this report is not represented or warranted to be timely, complete, accurate, or correct. This report is for informational purposes only and should not be considered a solicitation to buy or sell a security. Before acting on any information in this report, you should consider whether the information is suitable for your particular circumstances and, if necessary, seek professional advice. Assumptions, opinions, and estimates are based on our judgment as of the date of the report and are subject to change without notice. Valuentum is not responsible for any errors or omissions or for results obtained from the use of this report. Redistribution is prohibited without written permission. To license Valuentum research, contact us at valuentum@valuentum.com.

VALUENTUM

PayPal (PYPL) – Page 1 of 16

Download PayPal's 16-page report 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 14-May-2018

PayPal PYPL FAIRLY VALUED

Buying Index™ 6 **Value Rating**

Economic Castle	Estimated Fair Value	Fair Value Range	Investment Style	Sector	Industry
Attractive	$81.00	$65.00 - $97.00	LARGE-CAP BLEND	Information Technology	Financial Tech Services

PayPal's near-term top and bottom-line growth expectations remain robust. Increasing levels of competition are a real threat, however.

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™	NEGATIVE
Cash Flow Generation	STRONG
Financial Leverage	LOW
Growth	HIGH
Technical Evaluation	VERY BULLISH
Relative Strength	NEUTRAL
Money Flow Index (MFI)	NEUTRAL
Upside/Downside Volume (U/D)	BEARISH
Near-term Technical Support, 10-week MA	77.00

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)	$96,227
Avg Weekly Vol (30 wks)	43,103
30-week Range (USD)	68.61 - 86.32
Valuentum Sector	Information Technology
5-week Return	1.2%
13-week Return	1.4%
30-week Return	11.0%
Dividend Yield %	0.0%
Dividends per Share	0.00
Forward Dividend Payout Ratio	0.0%
Est. Normal Diluted EPS	3.27
P/E on Est. Normal Diluted EPS	24.1
Est. Normal EBITDA	6,200
Forward EV/EBITDA	20.4
EV/Est. Normal EBITDA	14.8
Forward Revenue Growth (5-yr)	14.6%
Forward EPS Growth (5-yr)	23.2%

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

Investment Highlights

- PayPal operates as a technology platform company that enables digital and mobile payments on behalf of consumers and merchants worldwide. The company's platform allows customers to pay and get paid, transfer and withdraw funds to their bank accounts, and hold balances in their PayPal accounts in various currencies. PayPal was spun off from eBay in July 2015.
- PayPal will continue to innovate and update its products and platform. For example, the firm recently updated its order-ahead function, which allows customer to have orders ready and paid for when they arrive at a store, but further innovation will be necessary to remain effectively competitive.
- PayPal's business is subject to extensive government regulation and oversight, as well as complex, overlapping and frequently changing rules, regulations and legal interpretations. Additionally, any factors that increase the costs of cross-border trade or restrict, delay, or make cross-border trade more difficult would lower its revenues and profits and could harm our business, providing additional geopolitical risk.
- PayPal continues to set itself up for long-term success. The firm has announced partnerships with Visa, MasterCard, and Discover that enhance customer service features, particularly in the area of digital payments. The company expects transaction revenue to grow ~20% in 2018, and non-GAAP earnings per share are expected to be $2.31-$2.34.
- Competition continues to increase for PayPal, but none may be more concerning than Amazon, which is reportedly offering discounts to retailers using Amazon Pay. Shares have been volatile on news surrounding its agreement with eBay, which was ultimately extended through 2023.

Relative Valuation

	Forward P/E	PEG	Price / FV
Bottomline Tech	NMF	NMF	113.2%
Fiserv	22.1	NMF	134.1%
Mastercard	29.4	2.2	106.3%
Visa	28.8	2.1	100.9%
Peer Median	28.8	2.1	109.7%
PayPal	**33.3**	**2.3**	**97.3%**

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

Returns Summary 3-year Historical Average

Return on Equity	10.9%
Return on Assets	4.7%
ROIC, with goodwill	17.7%
ROIC, without goodwill	27.9%

ROIC = Return on Invested Capital; NMF = Not Meaningful

Financial Summary

	----- Actual -----		Projected
Fiscal Year End:	Dec-16	Dec-17	Dec-18
Revenue	10,842	13,094	15,372
Revenue, YoY%	17.2%	20.8%	17.4%
Non-GAAP Operating Income	1,586	2,259	3,533
Non-GAAP EBIT %	14.6%	17.3%	23.0%
Non-GAAP Net Income	1,401	1,795	2,897
Non-GAAP NI Margin %	12.9%	13.7%	18.8%
Non-GAAP Diluted EPS	1.15	1.47	2.36
Non-GAAP Dil EPS, YoY %	15.1%	27.8%	60.8%
Non-GAAP FCF (CFO-capex)	2,489	1,864	3,547
Non-GAAP FCF Margin %	23.0%	14.2%	23.1%

In Millions of USD (except for per share items)

Leverage, Coverage, and Liquidity

In Millions of USD

Total Debt	1,000
Net Debt	-4,695
Total Debt/EBITDA	0.3
Net Debt/EBITDA	NMF
EBITDA/Interest	Excellent
Current Ratio	1.4
Quick Ratio	1.1

NMF = Not Meaningful

Structure of the Financial Tech Services Industry **EXCELLENT**

The financial tech services industry is primarily composed of firms that generate revenue by charging fees to customers for providing transaction processing and other payment-related services. Constituents operate in a rapidly-evolving legal/regulatory environment, particularly with respect to interchange fees, data protection, and information security. Several participants benefit from a significant competitive advantage – the network effect. As more consumers use credit/debit cards, more merchants accept them, thereby creating a virtuous cycle. The industry is one of the most attractive in our coverage.

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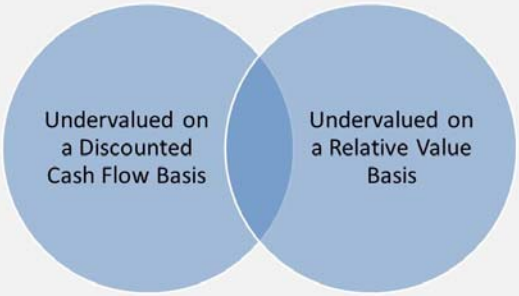
VALUENTUM

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.**

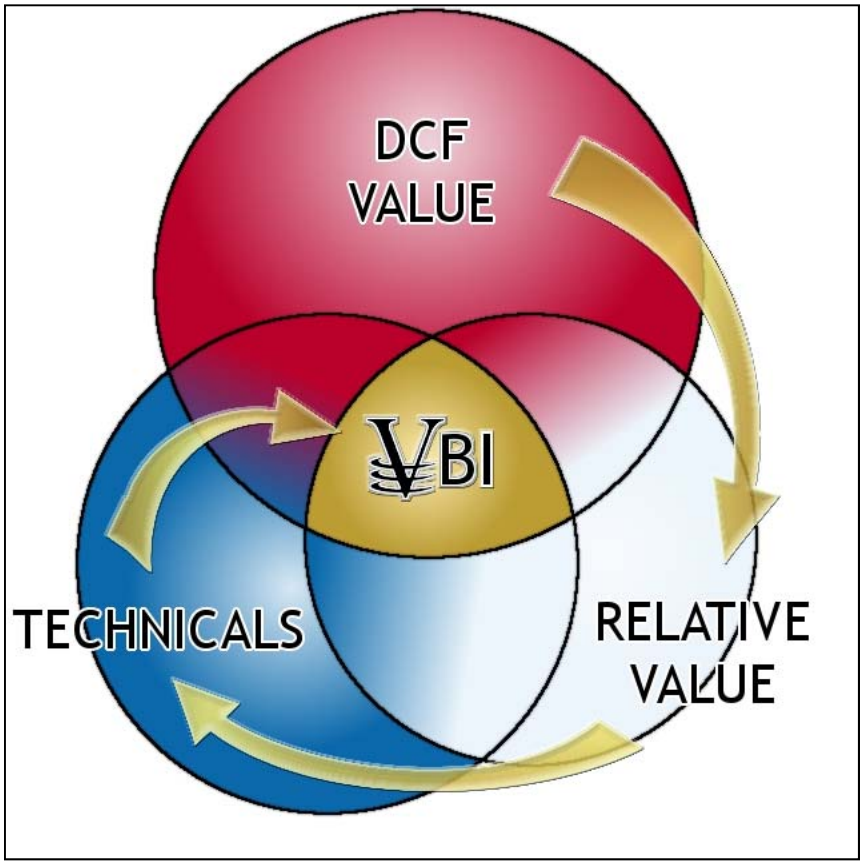
Company Name	Symbol	Sector	VBI
Amphenol Corp	APH	Information Technology	1
Arch Capital	ACGL	Financials	1
Boyd Gaming	BYD	Consumer Discretionary	1
Chart Industries Inc	GTLS	Materials	1
Churchill Downs	CHDN	Consumer Discretionary	1
Clorox	CLX	Consumer Staples	1
Fiserv	FISV	Information Technology	1
Graco	GGG	Industrials	1
H&E Equipment	HEES	Industrials	1
Illinois Tool Works	ITW	Industrials	1
Intercontinental	IHG	Consumer Discretionary	1
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
Owens Corning	OC	Industrials	1
Raytheon	RTN	Industrials	1
RBC Bearings	ROLL	Industrials	1
SBA Comm	SBAC	Telecom Services	1
Teledyne	TDY	Industrials	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.

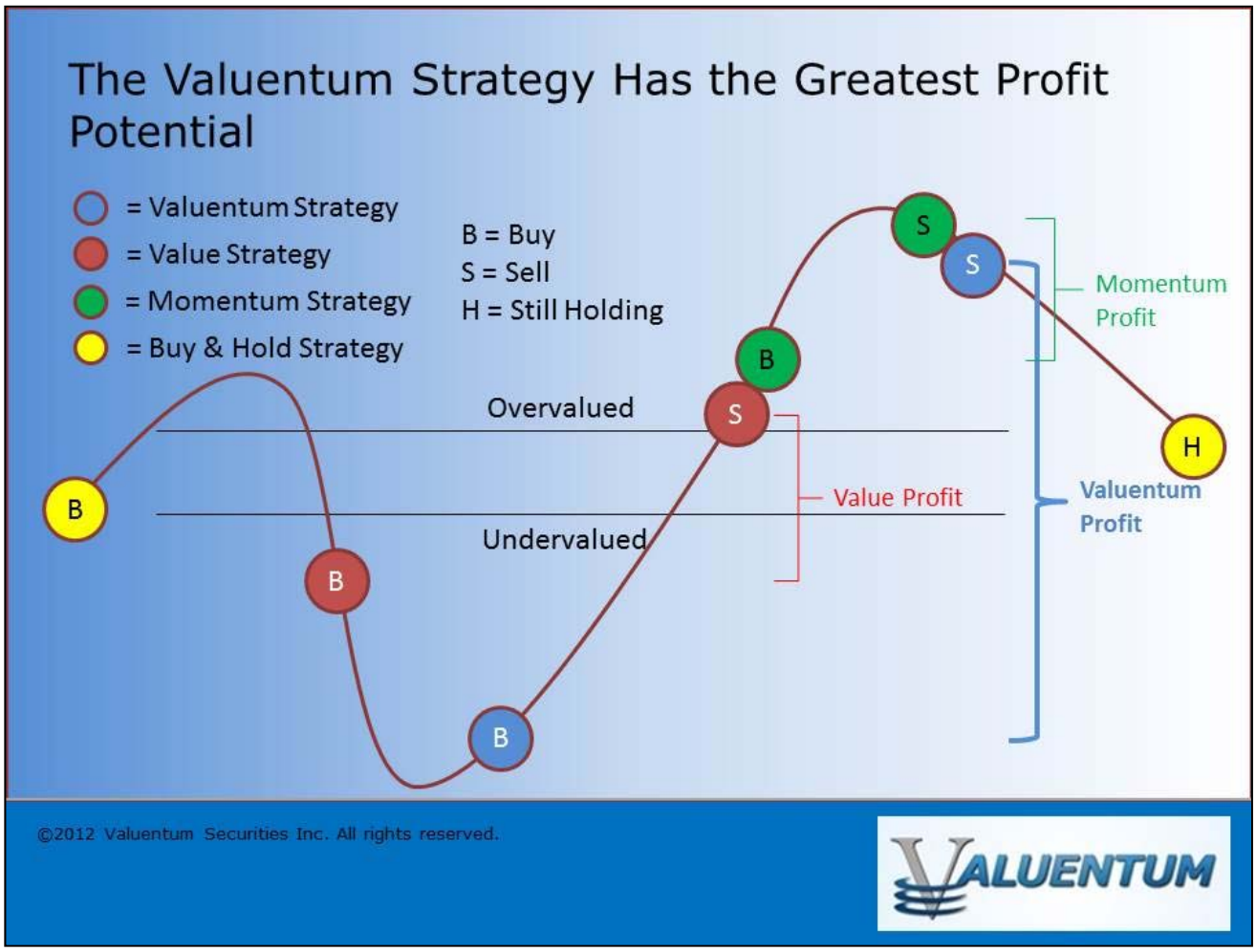


Illustration for educational purposes only.

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.

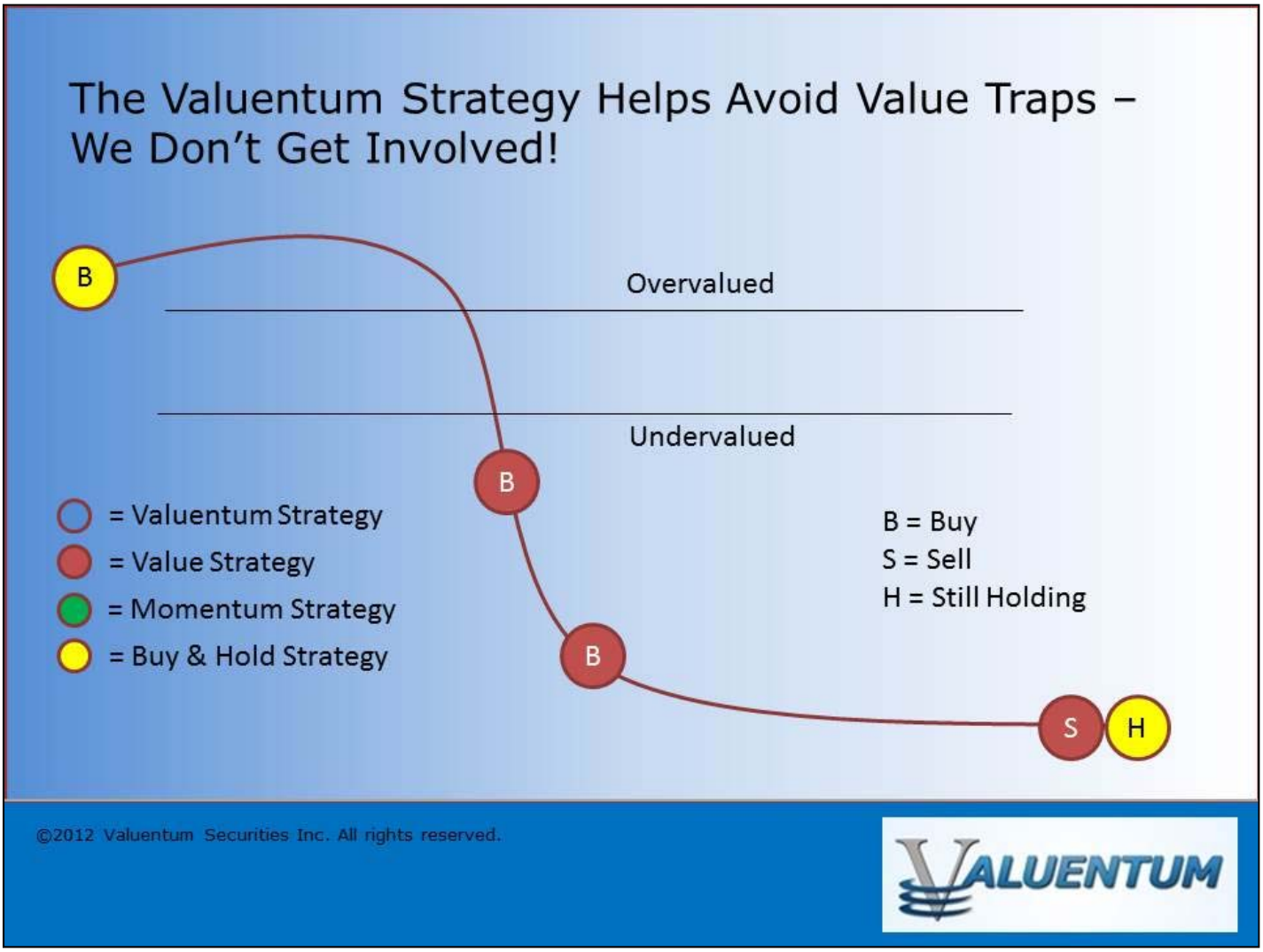


Illustration for educational purposes only.

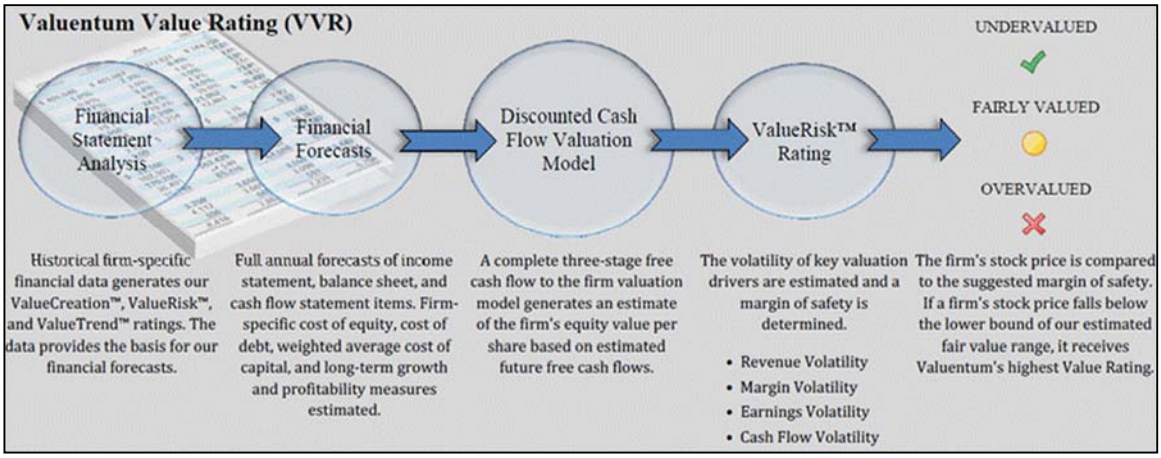
Our Methodology – The Valuentum Buying Index continued on next page

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.

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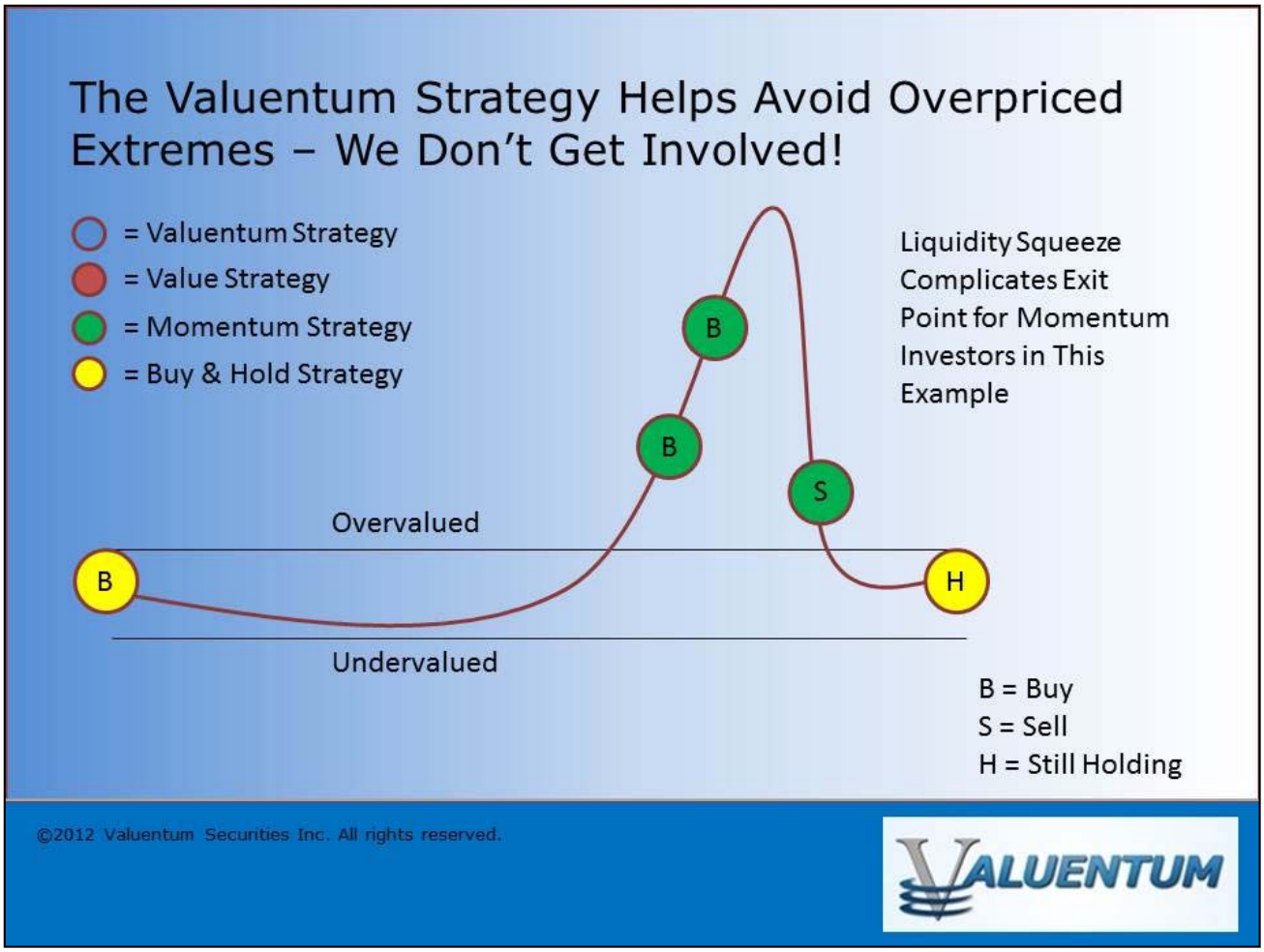

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II. The Valuentum Buying Index Incorporates A Forward-Looking Relative Value Assessment

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

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

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

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valuation criteria).

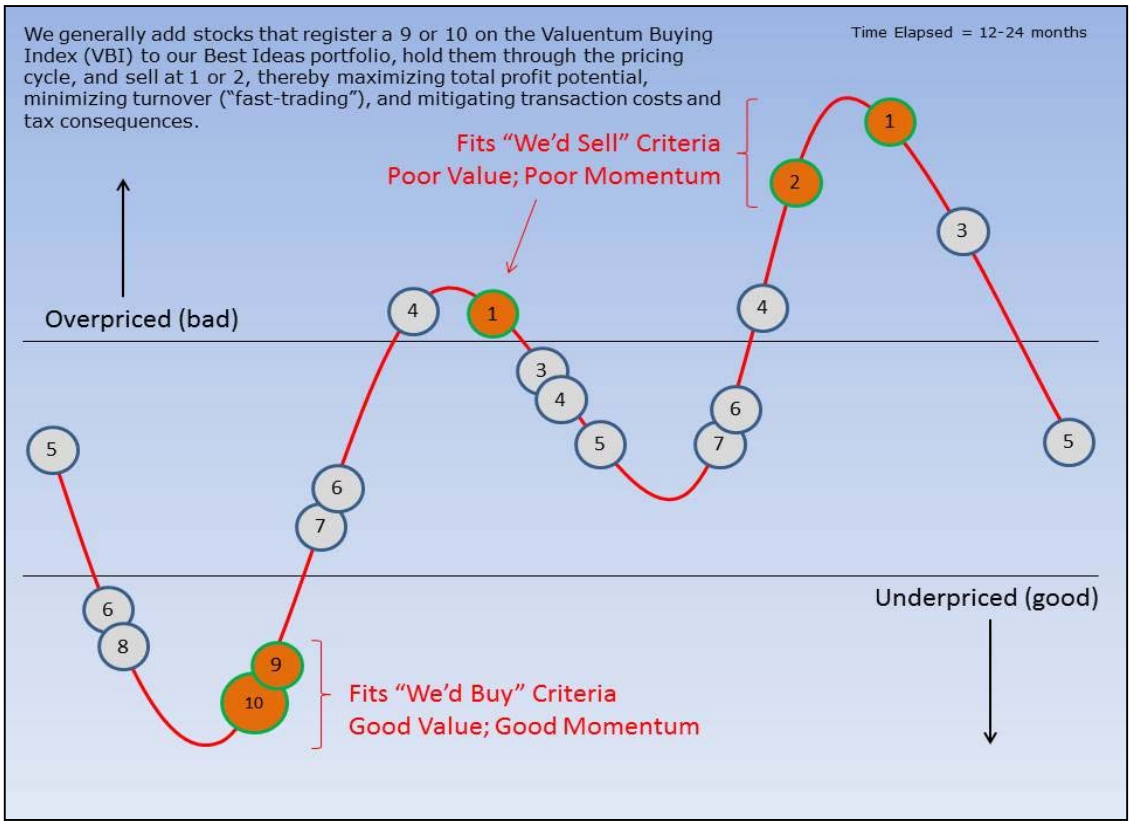
Rigorous valuation analysis and technical analysis are not mutually exclusive, and we believe both can be used together to bolster idea generation. An evaluation of a stock's moving averages, relative strength, upside-downside volume, and money flow index are but a few considerations we look at with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

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

Putting It All Together - the Valuentum Buying Index

Though the time frame varies depending on each idea, on a theoretically basis, we would expect our best ideas to "work out" over a 12-24 month time horizon (on average) -- the duration of any individual idea can vary considerably, however. We tend to include firms in the Best Ideas Newsletter portfolio when they register a 9 or 10 on our Valuentum Buying Index (VBI) and tend to remove firms from the Best Ideas Newsletter portfolio when they register a 1 or 2 on the Valuentum Buying Index.

In theory, the Valuentum Buying Index attempts to maximize profits on every idea within the Best Ideas Newsletter portfolio, with the understanding that momentum does exist and that prices over and under shoot intrinsic value all of the time. A value strategy (10 --> 5), for example, may truncate potential profits, while a momentum strategy (4 --> 1), for example, may ignore profits generated via value assessments. The Valuentum Buying Index seeks to capture the entire profit potential, as shown below.



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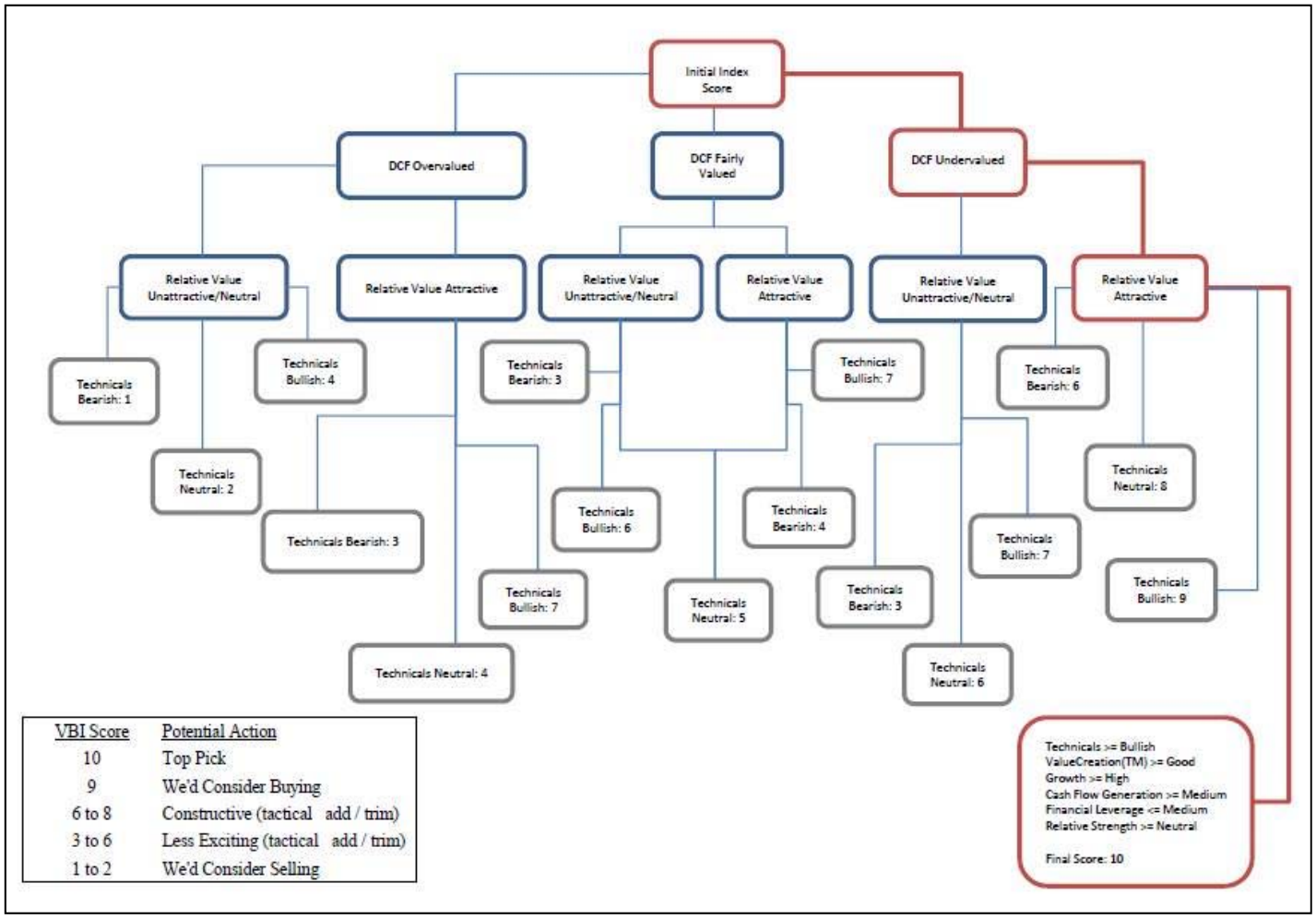
Our Methodology – The Valuentum Buying Index **continued from previous page**

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.



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About the Fair Value Range

By Valuentum Analysts

Understanding the Fair Value Range and Why It's Important

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

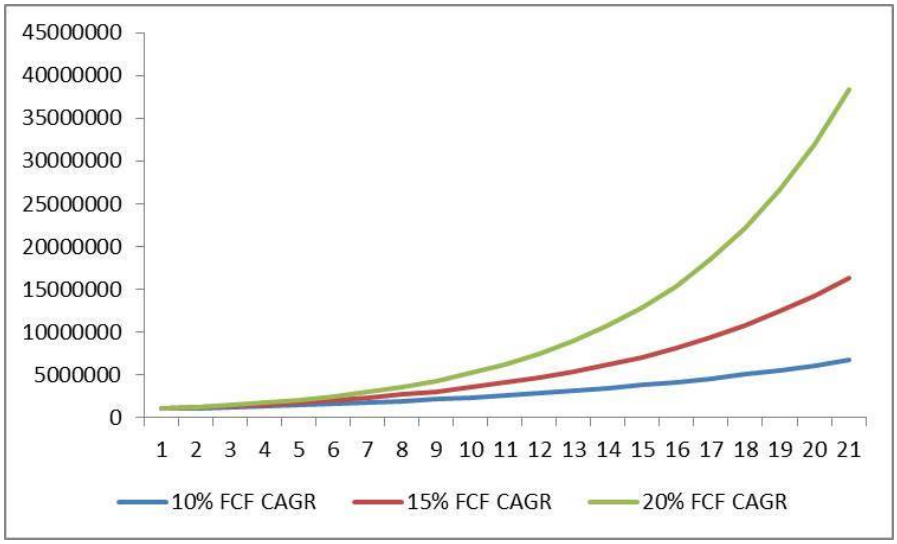
One of the most important concepts of the Valuentum methodology (and valuation in general) is the understanding that the value of a company is a range of probable valuation outcomes, not a single point estimate. Even well-seasoned stock analysts are guilty of saying that a company's shares are worth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

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

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

But why the large range in many cases?

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



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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.

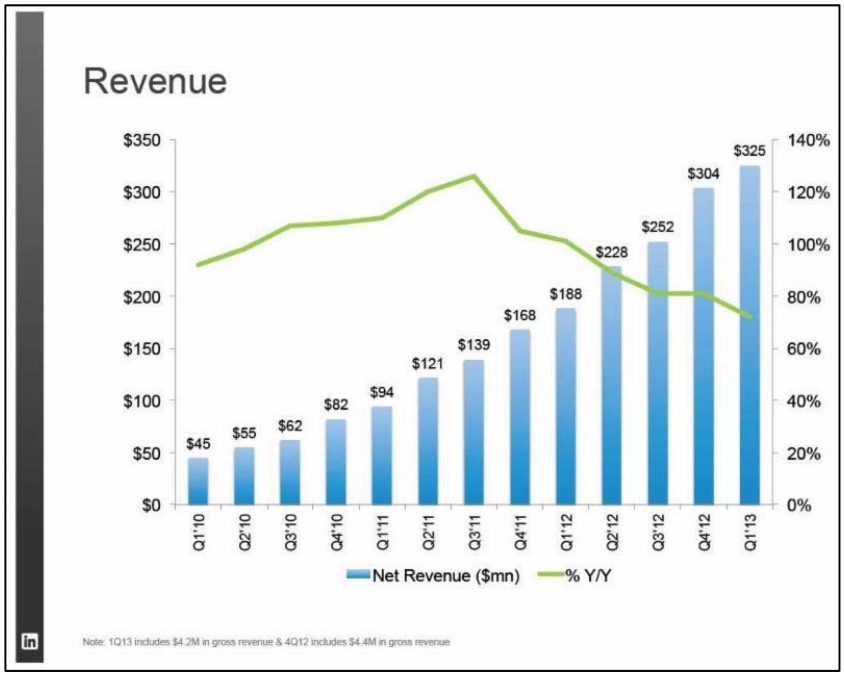

Image Source: LinkedIn

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.

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

We're scouring our coverage universe for firms that are trading outside of their respective fair value ranges. A firm trading below the low end of its fair value range, for example, is undervalued, while a firm trading above its fair value range is overvalued. The fair value range for each company captures the inherent uncertainty of the trajectory of that firm's unique future free cash flow stream. For the 1,000+ companies we include in our coverage universe, we provide a discounted cash flow derived fair value estimate and a corresponding fair value range -- *and a robust discounted cash-flow process is only one aspect of our service.*

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

By Valuentum Analysts

We often receive questions about how we use the Valuentum Buying Index (VBI) rating system, one of the key metrics we use to source ideas, but we think it is equally important to mention up front that it is only one of the many facets of our website and services. For example, if you haven't checked out the Dividend Cushion ratios on the stocks in your portfolio or the dividend growth product (from individual reports to the newsletter and beyond), surely you are not maximizing your membership! Don't forget about the Economic Castle rating and the Nelson Exclusive publication, too.

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

The Valuentum Buying Index Has Checks and Balances

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

Within any process, of course, we value the human, qualitative overlay, which captures a wealth of experience and common sense. We strive to surface our best ideas for members, and flying blind is never a good strategy, in our opinion. In probably one of the most obvious cases, for example, an experienced investor knows when a price-to-earnings (P/E) ratio isn't informative (as in the case of negative or negligible earnings), but a quantitative rating system that uses a P/E ratio may not know any better. That's why the VBI has checks and balances and focuses on the discounted cash-flow process first and foremost, but the human, qualitative overlay is still extremely important, especially when considering various business models and unique "un-modelable" risks. In our opinion, a golf club is only as good as the player that uses it, and in a similar light, a financial model or a rating system is only as good as the user that applies it.

That said, for the sake of transparency, we measure the performance* of the portfolios in the Best Ideas Newsletter and Dividend Growth Newsletter. The portfolios, in part, represent data points measuring the outcome of the work we do on the website, rolled into an assessment: our best ideas for each respective strategy. The ideas in the portfolios in the Best Ideas Newsletter and Dividend Growth Newsletter have been evaluated by our analyst team for consideration in the newsletter portfolios. The thoughts behind the weighting of each idea and the portfolio management process revealed in full transparency on a month to month basis may be worth the cost of a membership alone, even if you're not using the portfolios!

Here's why this is important. In a market environment where more than 90% of large-cap funds have trailed the S&P 500 in the 5-year period ending August 31, 2016, the Best Ideas Newsletter portfolio* has exceeded its benchmark return over a similar time period. What's more, we showcased this performance in full transparency, and we wrote every single day, and some days weren't all that great. When patience

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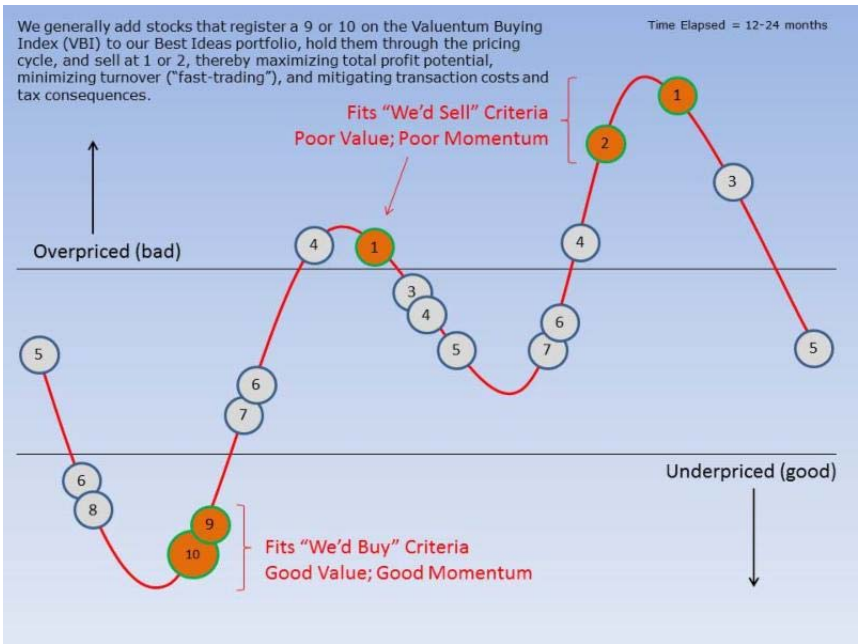
may be the secret to success in investing, a lot could have gone wrong with the temptation to do something each day. Obviously, we're very disciplined, but we also credit the portfolio outperformance to the VBI methodology itself. It is a very helpful tool.

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

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

That said, let's talk about how the VBI helps to inform which ideas we include in the Best Ideas Newsletter portfolio. This is where some clarification is probably important. For one, the word choice is critical, "inform," because the VBI is generally just one factor that goes into whether we add a company to the Best Ideas Newsletter portfolio, even if the VBI is one of the most important factors. Second, the timing element or duration concept is a key consideration. We've noticed via our statistical backtesting that a momentum factor can be much more pronounced (powerful) over longer periods of time. This was one of the interesting findings of our academic white paper study (2012). We try to consider this dynamic with the update cycle of our reports (and the time horizon for ideas to work out). That's why our reports are updated regularly (generally on a quarterly basis) or after material events and not daily or weekly. Perhaps most practically though, we don't think portfolio churn is the way to generate outperformance. Momentum may be high turnover, but Valuentum is low turnover.

Though the time frame varies depending on each idea that we consider for the Best Ideas Newsletter portfolio, we would expect our best ideas to generally work out over a 12-24 month time horizon (on average). Not all ideas will be successful, however. Our "holding period" is targeted to be much, much longer for some ideas in the Dividend Growth Newsletter portfolio, as income and dividend growth are other key factors (in addition to the Valuentum Buying Index and capital appreciation potential). The time horizon or duration concept is where the Valuentum Buying Index rating system becomes more complicated than a simple 1, 2, 3. For example, we tend to "add" stocks to the Best Ideas Newsletter portfolio when they register a 9 or 10 on the Valuentum Buying Index (VBI), "hold" them for some time depending on a number of variables (the VBI, market conditions, sector weightings within the portfolio itself), and then we tend to "remove" stocks from our Best Ideas Newsletter portfolio when they register a 1 or 2 on the VBI. You'll notice that we have a qualitative overlay for the Best Ideas Newsletter portfolio (and one for the Dividend Growth Newsletter portfolio, too, based on dividend-related considerations).



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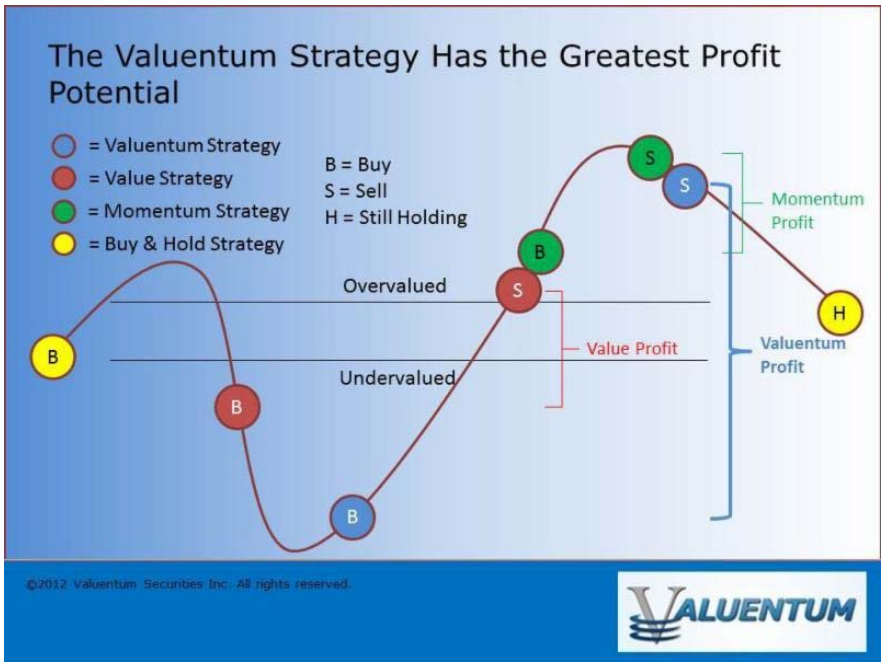
But why don't we churn our ideas by updating daily and trading a lot? Obviously, we don't think that's the secret to investment success. In quite the opposite approach, we strive to maximize profits on every idea that we pursue, with the understanding that momentum does exist and that prices over and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



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

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

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

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process, but the Valuentum team makes the allocation decisions of the newsletter portfolio on the basis of a number of other firm-specific and portfolio criteria. Sometimes, under certain market conditions, we may even have to relax the VBI criteria entirely in order to do what we think is required to achieve newsletter portfolio goals.

Some Examples of the Valuentum Buying Index In Action

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

There have been more straightforward opportunities in the Best Ideas Newsletter portfolio, too, especially in the case of EDAC Tech, which tripled since it was added to the newsletter portfolio (never registering below a 9 along the way), and then of course, Apple (APPL), Visa (V) and Altria (MO), but it is usually through the nuances of the process that one truly comes to understand it (as in the eBay example). Not to be overlooked either, the Valuentum Buying Index rating also informs us when we may consider "removing" a position from the newsletter portfolios. Kinder Morgan (KMI), for example, registered a 1 on the Valuentum Buying Index just prior to its notorious fall and dividend cut. The VBI ratings on each stock's most recent 16-page report, downloadable directly from the website at www.valuentum.com, reflect our current opinion on the company.

In all, the Valuentum Buying Index rating system, as with all methodologies, helps to inform the investment decision process, but in constructing the newsletter portfolio, a qualitative overlay is not only necessary, in my view, but helps to optimize performance. If the returns of the Best Ideas Newsletter portfolio during the past 5+ years are any measure of the VBI rating system, it is performing fantastically well. Of course, please always contact your financial advisor to determine if any idea or strategy may be right for you.

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About Our Name

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

-- Warren Buffett, Berkshire Hathaway annual report, 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 7

Valuentum's Best Ideas Newsletter is published monthly. To receive this newsletter on a monthly basis, please subscribe to Valuentum by visiting our website at www.valuentum.com. Or contact us at info@valuentum.com.

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