OUR BEST IDEAS NEWSLETTER

Valuentum Securities

Stock Analysis: From Value through Momentum Investing

December 15, 2018
Volume 8 Issue 12

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

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"There is no reason why we're not the top newsletter publisher out there given our track record. Start spreading the news!"

– Brian Nelson, CFA

Pay Attention – 2018 Was Another Fantastic Year!

You know how well the simulated Best Ideas Newsletter portfolio has done since inception through the end of 2017. But 2018 was yet another fantastic year. I'm not sure what in the world is going on out there, but our churn rate is not reflective of our performance at all. Are the sales tactics out there getting really aggressive?

By Brian Nelson, CFA

I'm not one for complaining, but this is getting a bit ridiculous. We released a study on our simulated Best Ideas Newsletter portfolio, a walk-forward test, as you know, **where the simulated portfolio outperformed the S&P 500 (SPY) since market inception based on any way you look at it. Not only that but it did so at a significantly lower level of volatility thanks to an outsize cash position.** Had one been fully allocated to the ideas in the simulated Best Ideas Newsletter portfolio at all times, one's performance would have been even better than presented (the portfolio had a 20%+ cash position during one of the best bull markets, and it still did better than the market's return!).

Here's the big question: **What is going on out there?** Because after looking at the performance of each individual idea in the simulated Best Ideas Newsletter portfolio this year, they continue to do well. **The S&P 500 is down approximately 1.4% on the year, and nearly 60% of our ideas are up on the year, and some a lot. Top-weighted idea Visa is up nearly 19%, offsetting all the negativity surrounding Facebook as an idea. Mid-weighted idea Cisco is up nearly 22%, while lower-weighted ideas Dollar General, PayPal, and Verint are all up over 10%.**

Remember – this simulated newsletter performance of ideas in 2018 comes after years and years of a strong showing already. So--when we say that Altria fell by 23%+ this year, we're okay with it because it has been up huge since it was originally a part of the simulated newsletter portfolio, and we still like it. When we say that General

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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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	1/1/2018 (1)	Div's	12/14/2018	2018 Hypothetical Return
Berkshire Hathaway	198.87		200.00	0.6%
Facebook	177.68		144.06	-18.9%
Alphabet	1,048.34		1,042.10	-0.6%
Visa	**114.57**	**0.88**	**135.09**	**18.7%**
Apple	170.16	2.82	165.48	-1.1%
SPDR S&P Dividend ETF	94.75	1.77	93.47	0.5%
Energy Select Sector SPDR	72.62	1.50	62.09	-12.4%
Health Care Select Sector SPDR	82.99	0.98	88.96	8.4%
Cisco	**38.67**	**1.28**	**45.82**	**21.8%**
Intel	46.38	1.20	47.86	5.8%
Johnson & Johnson	139.66	3.54	133.00	-2.2%
Altria	71.51	2.20	52.73	-23.2%
Booking Holding	1,750.09		1,807.14	3.3%
Chipotle	425.65		457.83	7.6%
Dollar General	**93.56**	**1.13**	**104.98**	**13.4%**
Gilead Sciences	72.19	2.28	65.57	-6.0%
General Motors	41.24	1.52	35.10	-11.2%
PayPal	**74.24**		**85.92**	**15.7%**
Verint Systems	**41.95**		**46.86**	**11.7%**
S&P 500 SPY	**267.84**	**3.67**	**260.47**	**-1.4%**

(1) We use the intra-day high on April 26 for Chipotle's add price, when members received the email notification.

See page 8 for more detailed information regarding the simulated newsletter portfolio.

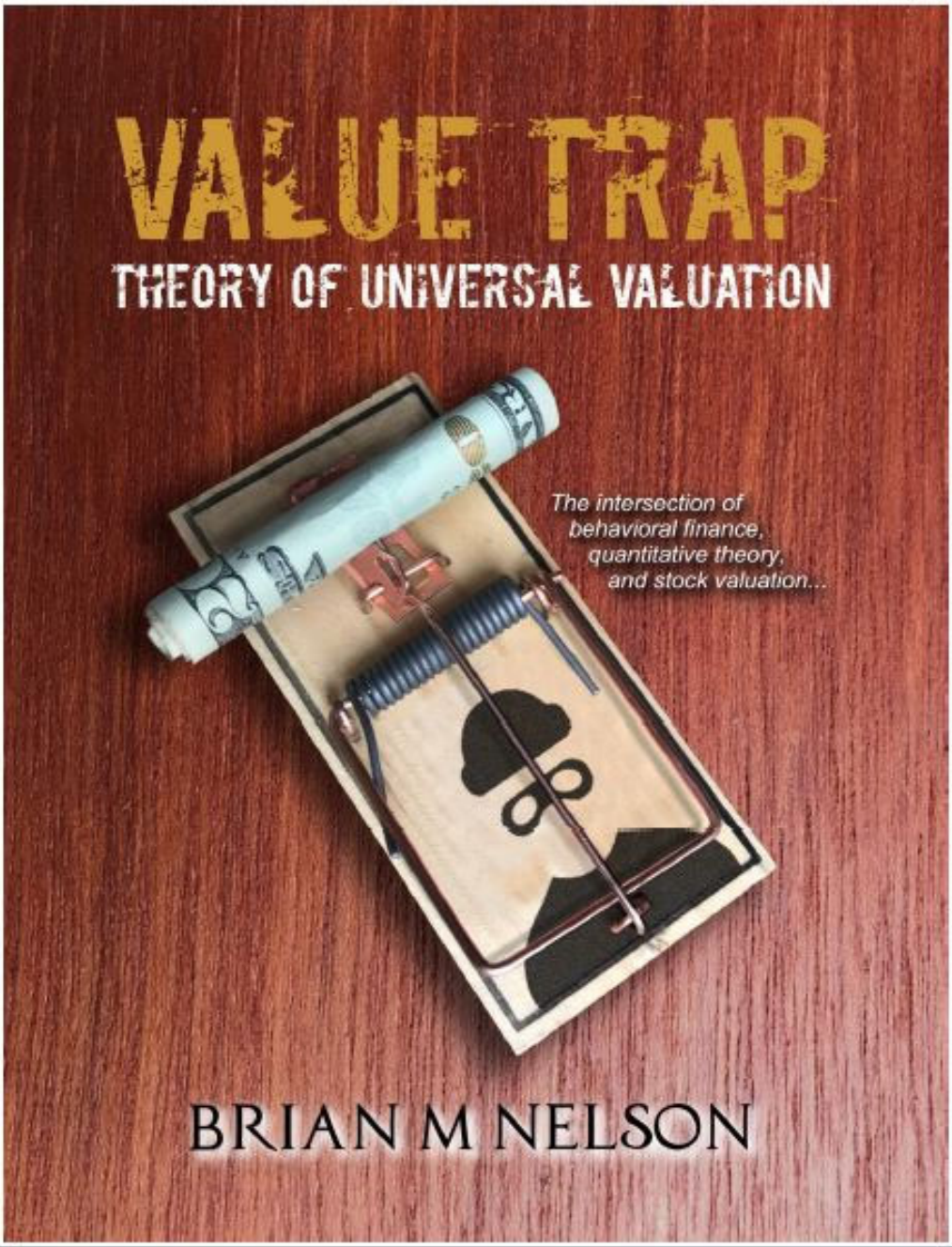
Motors is off about 11% this year, we're okay with it because we still believe shares are considerably undervalued and perhaps the most underappreciated play on electric vehicles. **When we note that Facebook is off about 19% this year, we're okay with it because it is still trading above the "average cost basis" from when it was added, and we maintain our view that shares are incredibly cheap. Yes, we still like Facebook a lot, and we would not be surprised to see the company's share price return to new highs!** We're also okay with the weakness in our diversified energy exposure in the Energy Select Sector SPDR. It is among the most conservative ways to gain exposure to an ultra-cyclical end market, and we think it rounds out the portfolio with some nice diversification benefits.

The top weighted ideas roughly balanced themselves out, as with the top-mid-tier ideas and the bottom-mid-tier ideas. However, the lower-weighted ideas did particularly well, and **how in the world could anyone be upset with the simulated newsletter portfolio having an outsize cash weighting in this ultra-volatile and down market.** Look--if this was the first year of the simulated Best Ideas Newsletter portfolio, I'd say this is an average showing, perhaps above average because a cost of a membership is so low. However, after all these years, and still the majority of ideas outperforming this year, and with our being okay with the ones that haven't done well, **I think 2018 was another fantastic year.**

If this was the only newsletter in your membership, **it would be worth it, by itself.** Remember—roughly 80%-90% of active fund managers have been underperforming the market in recent years. That puts us right up near the top with this simulated newsletter portfolio, and **we've had to write and defend every idea in full view along the way. We can't window dress. We have to own our mistakes, but we keep delivering time and time and time again.** Remember--with your membership you also get the Dividend Growth Newsletter, access to hundreds of stock and dividend reports and much more. I don't think I'm in the twilight zone, but our churn rate is reflective of a portfolio down 50% or something. **This newsletter is doing great!**

I hope that you enjoy this edition of the Best Ideas Newsletter--and ask questions!!! **There is no reason why we're not the top newsletter publisher out there given our track record.** Start spreading the news!

COMING SOON!



"IF I HAVE WRITTEN THIS BOOK IN THE FASHION AS I ENDEAVOR, I WANT EVERY SENTENCE, EVERY PARAGRAPH TO BE WORTH YOUR WHILE. I HOPE THIS TEXT STANDS THE TEST OF TIME AND EVEN SHAPES THE FUTURE." – BRIAN NELSON, CFA

Facebook to Test New Ad Feature

Image Shown: Facebook's share price performance since late 2017. Shares may be poised to breakout of a recent downtrend. Source: TradingView.com

Facebook has faced significant pressure from a number of sources in recent months, but we continue to like the stock, which may be poised for a technical breakout and appears undervalued.

By Kris Rosemann

It's no secret that simulated Best Ideas Newsletter portfolio idea Facebook (FB) has been working to right the ship while under an intense level of scrutiny from a variety of sources. The company has been caught in perhaps an unprecedented culmination of social and political pressures, but these are unprecedented times.

We continue to like shares of Facebook due to the robust free cash flow the company generates, its fortress-like balance sheet, and its current position in an online advertising duopoly along with fellow simulated Best Ideas Newsletter portfolio idea Alphabet (GOOG, GOOGL). Estimates for the 2018 calendar year suggest that Facebook controls ~19.5% of the nearly $280 billion digital ad market, second to only Alphabet's Google, which holds an estimated 31.5% share.

Facebook is now looking to expand the avenues through which it sells advertising, though its most recent endeavor is not exactly new as it explored a similar service around the time of its IPO in 2012. The company is reportedly testing the implementation of ads in its search results and Marketplace, a similar feature to Google's AdWords, and it plans to test the feature by letting a select group of advertisers display ads on search results pages in mobile in the US and Canada, with the potential for the feature to be expanded to other regions. Critics of Facebook may point to the new advertising feature as another potential exploitation of user data by corporations looking to sell more targeted ads, and this has been a key sticking point for the social pressure heaped on the company recently.

The move comes as Facebook and other social media entities, such as Snap (SNAP), continue to work with advertisers on monetizing the increasingly popular "stories" feature that has been a smash hit with users around the globe. Slowing revenue growth has also been a key feature of negative news surrounding Facebook of late, but we're less concerned with ongoing double-digit top-line increases at

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the social media giant than we are with significantly increased spending that appears to be at least in part influenced by outside pressures.

E-commerce giant Amazon (AMZN) is also making a significant push into the online advertising market as well and currently holds the number three position in the US behind Google and Facebook. The dominant player in online shopping has a treasure trove of user data and a massively popular platform, both of which bode well in its quest for a growing share of digital advertising. Perhaps the most interesting angle of Amazon's move is its proximity to points of consumer decision making. If users find an ad that strikes the buying bone properly, it may be possible that conversion rates of interested consumers on a platform such as Amazon's could eclipse that of the current players that require additional effort.

Amazon is still a long way from gaining material share, but its presence should not be written off entirely. The trade-off for advertisers to consider, at least for the time being, may be for a lesser reach compared to the potential exposure of Facebook or Google but with a more acute target that could bring potentially higher conversion rates. In any case, the days of Facebook and Google operating in a digital advertising may come to an end if Amazon is successful in its disruptive endeavors. It certainly would not be the first time the company has altered the landscape of an industry, albeit not one quite like this.

Regardless of the success of the young search ads test and despite recent scrutiny, we continue to like shares of Facebook, which are currently trading at a notable discount to our fair value estimate of $229 per share, an estimate that incorporates assumptions such as notable revenue growth deceleration and significant operating margin contraction. What's more is that shares may be poised to break out technically after months of selling pressure. We're going to keep highlighting this idea in the simulated Best Ideas Newsletter portfolio due in part to these two current attributes, the first of which is supported by a debt-free and cash-rich balance sheet and robust free cash flow generation.

Dollar General Slips on Lower Bottom-Line Guidance

Simulated Best Ideas Newsletter portfolio idea Dollar General continues to deliver consistent top-line performance, but higher than expected expenses in the second half of its fiscal 2018, including hurricane-related expenses and rising transportation costs, resulted in a reduction of operating margin and diluted earnings per share guidance. Net sales growth expectations were also tempered slightly.

By Kris Rosemann

Margin performance across the retail space has left a bit to be desired of late, "Retail Margins Weighed Down by Labor, Transportation Costs," and simulated Best Ideas Newsletter portfolio idea Dollar General (DG) was unable to avoid some of the pressures as its fiscal third quarter report, results released December 4, brought with it slightly lower margin expectations for the full fiscal year. We're sticking with our fair value estimate of $103 per share for the time being, and the company's ~1.1% dividend yield as of this writing looks to be quite well covered by free cash flow generation.

The notably consistent dollar store operator expects to deliver its 29th consecutive year of same-store sales growth in its fiscal 2018 (ends January 31) with guidance coming in at the middle of its previous range of mid-to-high two percent growth, and net sales guidance was rolled back slightly to ~9% from previous guidance of 9%-9.3%. The company adjusted its operating margin target for the full fiscal year to modestly below levels realized in fiscal 2017 compared to flat margin guidance previously, and diluted earnings per share guidance was lowered to a range of $5.85-$6.05 from $5.95-$6.15 previously. Management cited a $0.09 per share impact to this guidance range resulting from hurricanes and other disasters, rising transportation costs, and year-to-date results as the driver for the reduction.

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Net sales grew 8.7% on a year-over-year basis in Dollar General's fiscal 2018 third quarter thanks to a 2.8% increase in same-store sales from the year-ago period and contributions from new stores. The solid same-store sales growth marked the company's highest two-year same-store-sales stack in 11 quarters as the advance came on top of a 4.3% gain in same-store sales in the third quarter of 2017. However, customer traffic was approximately flat in the quarter as a higher average transaction amount with strength from the consumables, seasonal, and home categories drove the positive same-store sales results and offset weakness in the apparel category.

Dollar General's gross margin took a 39 basis point step back in the quarter from the year-ago period due to higher markdowns, increased transportation costs, and negative mix shift, most notably related to consumables sales, in addition to an increase in its LIFO provision. Meanwhile, SG&A spending as a percentage of revenue declined 21 basis points as a result of lower incentive compensation, advertising and supplies, and repairs and maintenance expenses as a percentage of sales, which were partially offset by higher depreciation expenses. These factors resulted in an 18 basis point operating margin contraction from the comparable period of fiscal 2017, but diluted earnings per share leapt 35.5% on a year-over-year basis thanks in large part to a materially lower tax rate.

Free cash flow generation through the first three quarters of fiscal 2018 jumped ~47% on a year-over-year basis to $963 million, which easily covered cash dividends paid in the period of $231 million. Dollar General plans to continue its ambitious store growth plans moving forward with expectations for 975 new store openings, 1,000 remodels, and 100 store relocations expected in fiscal 2019 on top of its targets of 900 new store openings, 1,000 remodels, and 100 store relocations in fiscal 2018. The company holds a net debt position of more than $2.6 billion as of the end of its fiscal third quarter, but its solid free cash flow generation should be able to handle this load. We think management could cut back on share repurchases as it bought back $298 million of its common stock in the third quarter of 2018 at an average price of $107.55, which is just above our fair value estimate for shares.

All things considered, we would have liked to see a bit more resilience in Dollar General's bottom-line in the near term, but the cost pressures it is facing are not a material surprise given recent trends seen from other retailers. We're going to keep highlighting the company as an idea in the simulated Best Ideas Newsletter portfolio as it remains a model of consistency with a same-store sales growth track record that spans decades and multiple economic cycles. Nevertheless, we're keeping an eye on the impact transportation costs are having on the retail space, and the tight capacity that is driving transportation rates may be one of the first impacts the proliferation of e-commerce has had on the dollar store discount space. Fuel prices may also be worth watching both in terms of additional transportation expenses and as it relates to the amount of disposable income among Dollar General's core customer base.

Verint Systems' Strategy Delivers

Actionable intelligence leader Verint Systems continues to deliver on its strategy in its 'Customer Engagement' segment, while its 'Cyber Security' segment is taking advantage of a number of trends. Management's initial guidance for next fiscal year impressed.

By Kris Rosemann

Simulated Best Ideas Newsletter portfolio idea Verint Systems (VRNT) turned in a solid fiscal third quarter report December 6 as momentum stemming from investments in advanced analytics, automation, and cloud across its actionable intelligence portfolio are driving expectations for ongoing demand growth. Organizations need this actionable intelligence to create an engaged workforce and smarter customer engagements, and its cybersecurity business is taking advantage of the necessity for protection against ever-advancing cyber threats. Initial guidance for the company's next fiscal year

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(ending January 2020) impressed as it called for better-than-previously expected top-line growth and ongoing double-digit earnings per share growth. We're sticking with our fair value estimate of $57 per share.

Revenue at Verint Systems in its fiscal third quarter (ended October 31) grew 8.3% on a year-over-year basis as its 'Customer Engagement' segment revenue led the way with an 8.7% advance. Management is excited about the progress it is making in automation, which it believes is a key differentiator for its business by providing it with advantages in customer innovation and robotics process automation. Its customer engagement strategy is based on four pillars: 1) offer customers a broad portfolio across all areas of the enterprise; 2) offer a full portfolio in the cloud, making it easier for organizations to transition to SaaS via a hybrid cloud strategy; 3) offer communications infrastructure and neutrality to provide flexibility in future infrastructure choices; and 4) infuse automation across the entire customer engagement portfolio.

In its 'Cyber Intelligence' segment, which grew revenue by 7.4% in its fiscal third quarter on a year-over-year basis, management points to strong demand for its data mining software, and ongoing momentum in large deals highlights its strength in automation and data analytics. The company expects three key trends to continue driving demand growth for its cybersecurity offerings: 1) security threats becoming increasingly more complex; 2) a shortage of data scientists and cyber analysts forcing security organizations to seek out automation to make up the difference; and 3) security organizations are looking for predictive intelligence. These trends, coupled with what we believe to be a sound strategy in customer engagement, lead management to target double-digit annual revenue growth over the long haul.

In its fiscal third quarter, Verint's non-GAAP gross margin expanded one percentage point from the year-ago period to 66%, while its non-GAAP operating margin leapt approximately three percentage points to 22.5% despite R&D spending as a percentage of revenue expanding slightly to 17%, which only further showcases the company's dedication to innovation. GAAP earnings per share in the quarter leapt to $0.29 from $0.04 in the year-ago period, and non-GAAP earnings per share advanced nearly 29% on a year-over-year basis. Though the company's strong free cash flow generation has eased our concerns with the discrepancy between its GAAP and non-GAAP earnings performance in the past, a narrowing gap between the two measures is comforting as it relates to potentially boosting the market's conviction in this idea.

Free cash flow generation remains strong at Verint, and through the first three quarters of the fiscal year ending January 2019, the measure jumped 51% to ~$104 million thanks to ongoing strength in cash flow from operations. At the end of the quarter, the company held Net debt, including long-term restricted cash, cash equivalents, time deposits, and investments of just under $358 million, down from ~$417 million at the beginning of the fiscal year.

Management reiterated its guidance for the current fiscal year with non-GAAP revenue expected to be $1.24 billion with ~7% 'Customer Engagement' segment revenue growth and ~10% 'Cyber Intelligence' segment revenue growth, and non-GAAP earnings per share guidance comes in at ~$3.15, which represents ~12% year-over-year growth. Looking ahead to next fiscal year, Verint expects non-GAAP revenue growth to come in at ~7% ($1.325 billion target) and non-GAAP earnings per share growth to be ~11% ($3.50 target) as it works to continue expanding non-GAAP operating margins.

We continue to highlight Verint Systems as an idea in the simulated Best Ideas Newsletter portfolio, and upside to our fair value estimate may exist if management is able to continue delivering margin expansion and hit its long-term target of double-digit top-line growth.

Valuentum's Best Ideas Portfolio

By Valuentum Analysts

Valuentum's BEST IDEAS -- as of December 14, 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	0.95	200.00	5.5%-10%
Facebook	FB	0.00%	$229.00	Very Attractive	6	0.63	144.06	5.5%-10%
Alphabet - Class C	GOOG	0.00%	$1529.00	Very Attractive	6	0.68	1042.10	5.5%-10%
Visa	V	0.73%	$141.00	Attractive	6	0.96	135.09	5.5%-10%
Apple Corp.	AAPL	1.73%	$236.00	Highest Rated	3	0.70	165.48	4%-5.5%
SPDR S&P Dividend ETF	SDY	2.40%	NA	NA	UR	NMF	93.48	4%-5.5%
Energy Select SPDR	XLE	2.96%	NA	NA	UR	NMF	62.06	4%-5.5%
Health Care ETF	XLV	1.38%	NA	NA	UR	NMF	88.96	4%-5.5%
Cisco	CSCO	2.78%	$54.00	Very Attractive	6	0.85	45.82	2.5%-4%
Intel	INTC	2.48%	$56.00	Attractive	4	0.85	47.86	2.5%-4%
Johnson & Johnson	JNJ	2.44%	$137.00	Attractive	6	0.97	133.00	2.5%-4%
Altria Group	MO	5.93%	$67.00	Very Attractive	6	0.79	52.73	2.5%-4%
Booking Holdings	BKNG	0.00%	$2092.00	Highest Rated	4	0.86	1807.14	1.5%-2.5%
Chipotle	CMG	0.00%	$469.00	Very Attractive	6	0.98	457.83	1.5%-2.5%
Dollar General	DG	1.09%	$103.00	Attractive	6	1.02	104.98	1.5%-2.5%
Gilead Sciences	GILD	3.37%	$92.00	Very Attractive	3	0.71	65.57	1.5%-2.5%
General Motors	GM	4.33%	$54.00	Attractive	7	0.65	35.10	1.5%-2.5%
PayPal	PYPL	0.00%	$109.00	Attractive	6	0.79	85.92	1.5%-2.5%
Verint Systems	VRNT	0.00%	$57.00	Very Attractive	3	0.82	46.86	1.5%-2.5%
Cash consideration	-	-	-	-	-	-	-	5%-30%

UR = Under Review
This portfolio is not a real money portfolio. Data as of December 14, 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.

Marathon Oil: Riding a Rollercoaster

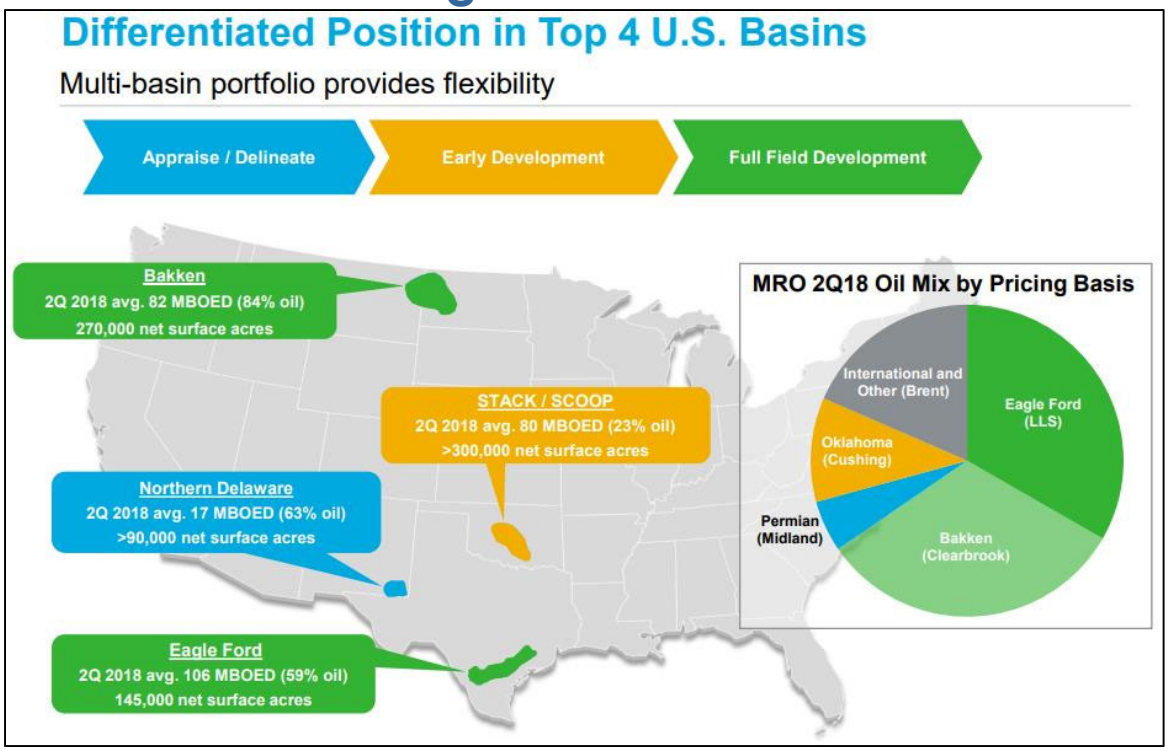

Image Source: Marathon Oil Investor Presentation

Let's take a look at how Marathon Oil, a midsized oil & gas producer, is navigating capricious oil markets at a time when the industry is waiting to see what impact the OPEC+ production cut deal might have on global energy markets.

By Callum Turcan

Key Takeaways

Marathon Oil has built its asset base around four key unconventional oil and gas plays in the US in the Permian Basin, the SCOOP/STACK, the Eagle Ford, and the Bakken. Its goal is to develop well locations within its unconventional drilling inventory that are liquids-rich, enabling the firm to grow crude production, which carries higher margins.

In light of recent geopolitical events, it is possible oil prices will begin to firm up starting in 2019 as a notable amount of supply is removed from the market. Strong non-OPEC supply growth, particularly in America and Brazil, creates a ceiling for oil prices, but that doesn't mean there isn't room to run after the recent tumble.

In order to manage a portion of the inherent risk being an upstream operator entails, Marathon Oil hedges a portion of its expected production. Oil and natural gas liquids sales generate the vast majority of its Marathon Oil's revenue, and natural gas liquids realizations tend to be closely correlated with WTI.

Should things pick up in the global crude market Marathon Oil could have an oil-rich growth runway at its disposal. We currently value shares of Marathon Oil at $20 each, and shares yield just under 1.3% as of this writing.

Introduction to Marathon Oil

In 2011, Marathon Oil Corporation (MRO) split its upstream division from its downstream division, creating two independent, publicly-traded companies. Marathon Oil was then a pure upstream player that solely

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focuses on exploring, appraising, and producing raw energy resources from oil & gas plays around the world, and Marathon Petroleum Corporation (MPC) became a midstream and downstream player that focuses on both operating industry-specific infrastructure (pipelines, processing plants, storage facilities) and refining oil into petroleum products.

Marathon Oil has built its asset base around four key unconventional oil and gas plays, or operations that utilize horizontal drilling and hydraulic fracturing to unlock vast amounts of recoverable hydrocarbons, in the US in the Permian Basin, the SCOOP/STACK, the Eagle Ford, and the Bakken. During the third quarter of 2018, Marathon Oil pumped 303,000 barrels of oil equivalent (BOE) net per day from its domestic division. The firm also has a sizeable presence in Equatorial Guinea and a very small footprint in the UK North Sea. Last quarter, Marathon Oil produced 112,000 BOE/d net from its international division.

With a company-wide quarterly production base of 415,000 BOE/d net Marathon Oil is classified as a midsized upstream operator, and roughly 65% of its output is liquids, making the firm highly levered to changes in oil prices. Natural gas liquids and condensate prices are also heavily influenced by global oil prices.

Business Developments

Management has been allocating capital towards developing the firm's four unconventional assets as Marathon Oil aims to grow its higher margin oil production streams. The company's total US production grew by 59,000 BOE/d to 303,000 BOE/d net in the third quarter of 2018 from the year-ago period. Domestic oil production rose by 34,000 bpd net while its natural gas liquids output jumped by 14,000 bpd net to 58,000 bpd, highlighting its liquids-rich drilling inventory. Organic growth more than offset the output Marathon Oil lost when it divested its non-operated working interests in three conventional projects this year (two in the Gulf of Mexico and one CO2 flood project in Texas).

However, during this period the firm's international output dropped by 53,000 BOE/d to 112,000 BOE/d net. This is largely due to the firm exiting Libya by selling its stake in the Waha Concession to Total SA (TOT) for $450 million and Kurdistan by selling its non-operating working interest in the Sarsang and Atrush blocks.

Company-wide production growth came in at only 6,000 BOE/d net in the third quarter of 2018 from the comparable quarter of 2017. When adjusting for divestments, Marathon Oil's output rose by 56,000 BOE/d net over that period. When analyzing publicly-traded upstream companies that are fond of touting adjusted production growth figures, it is important to identify the discrepancy between it and actual production growth.

Marathon Oil's divestment program is nearing an end. After selling off its high-cost oil sands division back in 2017 for $2.5 billion, various conventional assets over the past three years, and pieces of its international portfolio, there isn't much left for Marathon Oil to sell. Its transformation is nearly complete. Reportedly, Marathon Oil is actively marketing its UK North Sea assets, which produced less than 10,000 BOE/d net last quarter. The sale of Marathon Oil's working interest in the Foinaven fields and the Brae complex is expected to raise a couple hundred million dollars and would likely represent the last significant divestment from this multi-year transformation.

New Strategy and a New Play to Boot

Going forward, Marathon Oil will be doing things a little differently. Its goal is to develop well locations within its unconventional drilling inventory that are liquids-rich, enabling the firm to grow crude production, which carries higher margins. Without being held back by its very uneconomical oil sands mining unit and the lack of focus a far-flung asset base inevitably creates, Marathon Oil aims to emerge from its transformation as a reinvigorated force in the unconventional upstream world.

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Marathon Oil moved into Louisiana's emerging Austin Chalk play earlier this year and has since built up a 240,000 net acre position in the area. 3D seismic mapping activities are underway, and Marathon Oil is in the process of drilling its first exploration well targeting the play. Louisiana's Austin Chalk formation is still in the very early stages of development, and any exploration upside is highly speculative. There was a modest amount of conventional development activity targeting the formation back in the 1990s, but that offers only limited insight into the play. The goal is to uncover additional liquids-rich well locations to add to Marathon Oil's drilling inventory.

Buybacks on Deck?

Due to Marathon Oil's strong balance sheet, the firm was able to repurchase another $150 million of its shares under its existing buyback program during the fourth quarter of 2018 as of a mid-December update from management. Marathon Oil has now spent $650 million in the year-to-date period repurchasing its stock with $850 million in buyback authority remaining. The company is sitting on nearly $1.6 billion in cash and cash equivalents, but it does hold ~$5.5 billion in long-term debt. As of the end of the third quarter, management estimates its net debt-to-EBITDA ratio at less than 1x, which is among the lowest in its peer group.

During Marathon Oil's latest quarterly conference management commented on its buyback program:

> *"Our view is that a discipline[d] repurchase of our shares is a good use of capital and it offers very competitive returns given our current market valuation. The pace of that buyback is going to be governed or informed by our sustainable free cash, organic free cash flow generation. It, we do not want that program reliant on disposition proceeds. That is not the intent."*

It appears more buybacks could be on tap, but it depends on how much Marathon Oil allocates to capital expenditures next year in light of the ongoing turbulence in global energy markets. It is worth noting, however, that the company repurchased $349 million in shares in the first nine months of 2018 despite only generating $310 million in traditional free cash flow. Dividends paid in the period were $128 million. Management does not define organic free cash flow generation in the traditional sense (operating cash flow less all capital spending). Instead, it excludes the impact of changes in working capital to operating cash flow, subtracts development capital spending and dividends paid in place of all capital spending, and adds back "return of capital & other" from its equity investment in EG LNG. We prefer the use of traditional free cash flow in evaluating sustainable capital allocation policies.

Marathon Oil's next debt maturity isn't until 2020 when $600 million comes due, which provides it with some nice near-term flexibility. The company also extended the maturity of its undrawn $3.4 billion revolving credit line by a year to May 28, 2022, which gives the firm ample financial flexibility to go along with its current ratio of 1.4x.

Recent Developments in the Global Oil Industry

Starting in early-October, the value of both crude oil benchmarks, Brent and West Texas Intermediate, began to move precipitously lower as worries of a coming glut prompted investors to exit their long crude positions. US sanctions on Iran weren't as heavy-handed as the market had expected as eight nations were given waivers to continue importing Iranian oil supplies. That list includes mega-importers China, India, Japan, and South Korea, along with Italy, Turkey, Greece, and Taiwan. Those waivers last for six months, but there is a chance the US government will extend them in order to keep a lid on oil and thus gasoline prices.

From October 2 to December 6, spot prices for Brent fell from $85.63 to $57.83 a barrel. Over that period, spot prices for WTI slipped from $75.16 to $51.07 a barrel. OPEC+ members (in particular, Russia and Saudi Arabia) ramped up production expecting Iranian oil exports to begin moving swiftly lower, but that didn't come to pass. The world was once again swimming in oil.

*Marathon Oil…*continued on next page

Marathon Oil...from previous page

The slide in crude prices encouraged OPEC+ to agree to cut 1.2 million barrels of daily oil production from the market starting in January 2019 at the group's meeting December 7. Oil prices have had a mostly muted response to this news and are only up modestly from where they were trading at before the deal was announced. As per the terms of the agreement, OPEC pledged to reduce their collective output by 800,000 bpd and the non-OPEC member nations pledged to reduce their collective output by 400,00 bpd from October 2018 levels. Saudi Arabia and Russia represent the bulk of those reductions.

Alberta also announced that it was going to cut 325,000 bpd of production from the market during the first quarter of 2019, which will move down to just 95,000 bpd by the end of next year. The Canadian province is hoping that the expected drawdowns in Alberta's oil inventories will reduce regional pricing differentials relative to WTI as the industry waits for a more permanent solution to the province's takeaway problems (more pipeline takeaway capacity, additional regional refining capacity, and material increases in crude-by-rail takeaway capacity).

Output from Libya's Sharara oil field was recently shut-in due to protests at the facility, which removed 315,000 bpd from the market. That facility supplies electricity to the El Feel oil field, which was also recently shut-in due in part to the Sharara facility being forced offline and in part due to protests at the El Feel oil field. This will remove another 70,000 bpd from the market, but it is worth noting that these are very recent developments and the market is still watching these events unfold. If both of these Libyan oil fields are forced offline for a prolonged period of time, that will fundamentally change the supply-demand dynamic for oil markets heading into 2019. Libyan oil output came close to 1.3 million bpd in November 2018.

It is important to keep in mind that global demand for oil has historically moved lower during the latter part of the fourth quarter heading into the first quarter of the New Year, before rebounding on a sequential basis in the second and third quarters. Below is a graph from the International Energy Agency from November 14 that highlights its expectations for global crude markets through the end of 2019. Global oil demand growth is expected to come in at 1.3 million bpd in 2018 and 1.4 million bpd in 2019, but that won't be enough to stop a projected build in global oil inventories of 2 million bpd and 1.5 million bpd during the first and second quarters of 2019, respectively, according to the IEA. This was the agency's forecast before the OPEC+ deal was announced, the cut out of Alberta was made public, and recent events in Libya, so the dynamics may have changed.

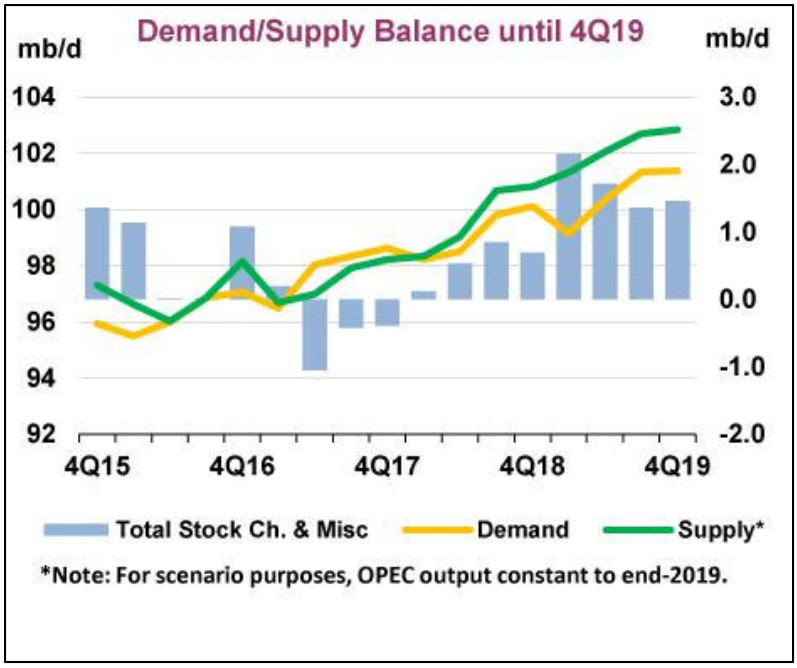

Image Source: IEA

Marathon Oil...continued on next page

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In light of recent geopolitical events, it is possible oil prices will begin to firm up starting in 2019 as a notable amount of supply is removed from the market. Strong non-OPEC supply growth, particularly in America and Brazil, creates a ceiling for oil prices, but that doesn't mean there isn't room to run after the recent tumble. That being said, any potential price increases are far from guaranteed as we have yet to see what the average compliance rate will be among OPEC+ members and Albertan oil producers.

Realizations and Hedging Strategies

Raw energy resource producers operate at the mercy of global pricing benchmarks. The price oil and gas producers receive for their oil, condensate, natural gas liquids, and natural gas production is a function of those benchmarks, with other factors coming into play as well. Those other factors include the impact regional pricing differentials, hedging programs, firm transportation agreements (giving oil supplies access to out-basin markets), and quality adjustments have on raw energy resource realizations.

In order to manage a portion of the inherent risk being an upstream operator entails, Marathon Oil hedges a portion of its expected production. Oil and natural gas liquids sales generate the vast majority of its Marathon Oil's revenue, and natural gas liquids realizations tend to be closely correlated with WTI, especially for American upstream players.

As of early-November, Marathon Oil hedged 95,000 bpd of its domestic fourth quarter oil production through three-way collars benchmarked to West Texas Intermediate. During the third quarter of 2018, Marathon Oil pumped out a net 168,000 bpd of crude oil from its US operations (adjusted for divestments). With roughly half of its expected US oil production hedged this quarter, Marathon Oil has some downside protection from the recent fall in WTI.

This hedging strategy had a weighted-average floor and ceiling price per barrel of $52.11 and $57.65, respectively (as of early-November). When WTI trades in that range, Marathon Oil realizes market prices for its hedged oil sales (minus any premiums paid, regional differentials and transportation expenses).

WTI is down by roughly a third since its early-October peak, which will drag down Marathon Oil's liquids realizations this quarter. While American natural gas prices, measured by the Henry Hub benchmark, have done quite well during the fourth quarter, that will likely not be enough to offset the impact of WTI moving lower. As an aside, the market expects Henry Hub to move below $3 per million British thermal units by April 2019 from over $4 in January 2019. That would put Henry Hub back down to where it was trading at for most of 2018.

Looking ahead at 2019, Marathon Oil's oil hedging position is much lighter. The company had hedged only 60,000 bpd of its expected 2019 oil production by early-November. That output is hedged at a weighted-average per barrel price of $49.59, $56.67, and $73.18 for the sold puts, floor, and ceiling, respectively.

Note that while the floor of its hedging program has increased by $4.56 per barrel compared to its hedging position this quarter, a positive, the weighted-average price of its sold puts has climbed upwards by $4.38 per barrel. If WTI trades below $49.59 next year for a sustained period of time next year, Marathon Oil's oil hedging program starts working against it.

Strip pricing for WTI as of this writing indicates that American light sweet oil prices will trade between $52–$54 per barrel throughout 2019, but due to the volatile nature of raw energy resource prices, the futures curve could change materially in a short period of time. Including the impact of its hedging program, Marathon Oil realized an average price of $59.90 per barrel for its US oil production during the first nine months of 2018.

Marathon Oil will be able to realize $56.67 per barrel of its hedged oil production next year as things stand today, while most of its crude output may very well be sold at market prices that are currently below the firm's realizations in 2018. If there isn't a rebound in oil prices, that will make it significantly harder to grow its revenue streams as expected oil production growth is counterbalanced by lower liquids realizations.

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Marathon Oil...from previous page

Beyond hedging its exposure to fluctuations in WTI, Marathon Oil has also hedged a portion of its in-basin differential risk via Midland-to-Cushing basis swaps. Crude sold in the Permian Basin is expected to fetch $8-9 per barrel below WTI until June 2019. Starting in June, the differential steadily winds down to negligible levels by the end of next year, according to the futures curve.

Marathon Oil has entered into Midland basis swaps that cover 10,000 bpd of its Permian oil output through the end of 2019. That ensures its differential will only be $0.67 a barrel below WTI in this quarter and $0.82 per barrel below WTI next year for its hedged Permian oil sales. During the third quarter of 2018, Marathon Oil pumped 12,000 barrels of crude per day net out of the Permian. Its Midland basis swaps will cover most of its expected Permian oil output this quarter and a large portion of its expected crude output next year.

United States Crude Oil Derivatives

As of November 5, 2018

Crude Oil (Benchmark to NYMEX WTI)	4Q18	FY 2019	FY 2020
Three-Way Collars			
Volume (BBLs/day)	95,000	60,000	-
Weighted Avg Price per BBL:			
Ceiling	$57.65	$73.18	-
Floor	$52.11	$56.67	-
Sold put	$45.21	$49.59	-
NYMEX Roll Basis Swaps			
Volume (BBLs/day)	-	60,000	-
Weighted Avg Price per BBL	-	$0.38	-
Midland to Cushing Basis Swaps			
Volume (BBLs/day)	10,000	10,000	15,000
Weighted Avg Price per BBL	$(0.67)	$(0.82)	$(0.94)

United States Natural Gas Derivatives

As of November 5, 2018

Natural Gas (Benchmark to NYMEX HH)	4Q18	1Q19
Three-Way Collars		
Volume (MMBtu/day)	160,000	100,000
Weighted Avg Price per MMBtu:		
Ceiling	$3.61	$3.75
Floor	$3.00	$3.00
Sold put	$2.50	$2.50

Image Source: Marathon Oil Corporation

Conclusion

This may seem trite, but at the end of the day where oil prices end up is what matters most. Almost two-thirds of Marathon Oil's production is liquids, making it highly levered to changes in oil prices. Management has stated in the past it will adjust the capital expenditure budget of Marathon Oil to match a lower oil pricing environment in order to preserve cash flow if necessary. In our opinion, management wants to communicate that the firm won't try to grow when energy investors are clearly signaling the market is already well-supplied.

With plenty of liquidity, Marathon Oil appears to have the financial flexibility to navigate the capricious oil market. When things pick up in the global crude market, which could happen sooner than investors expect in light of ongoing production cuts and other disruptions around the world, the company should have an oil-rich growth runway at its disposal. We currently value shares of Marathon Oil at $20 each, and shares yield just under 1.3% as of this writing.

Automakers Gain on Tariff Easing

An easing of tariffs on auto imports to China, as President Trump had previously hinted, has improved sentiment across the auto manufacturing space as investors eye up the potential for more free exchange of autos between the world's two largest economies.

By Kris Rosemann

US equities continue to be quite sensitive to US-China trade talk reports, and the auto manufacturing space has been a recent beneficiary of favorable developments. China (FXI) is temporarily reducing its auto import tariff to 15% from 40%, a win President Trump had pointed to as a positive development resulting from his meeting with Chinese officials during the recent G20 summit. The month of November marked the sixth straight month of declining car sales in the world's second-largest economy, which could bring the Chinese auto market to its first annual decline since 1990.

Shares of a number of automakers moved higher following the initial news December 11 as the move brings the import tax automakers from the US pay in line with that of other countries and to the rate that had been in place prior to the escalation of trade tensions earlier this year. However, those that stand to gain the most from the change may not be American companies but rather foreign automakers that produce cars in the US for the Chinese market, including BMW AG (BMWYY) and Daimler (DMLRY). Daimler expects to benefit from the potential tariff reduction as it had warned earlier in 2018 over the impact import tariffs would have on its high-margin Mercedes-Benz vehicles it imports to China from the US. Six of China's top ten selling US auto imports in 2018 are expected to be BMW or Mercedes SUVs.

China is the largest market by units sold for simulated newsletter portfolio idea General Motors (GM), but it operates in the country via multiple joint ventures and has in-country production of nearly all of its vehicles and parts sold there. Detroit-rival Ford (F) also produces a large number of its China-bound offerings in the country, but its luxury brand Lincoln line-up, which typically carries higher margins, is imported to China. Fiat Chrysler (FCAU) is in a similar boat as Ford with a bulk of its production for the Chinese market taking place in China, but it does import a number of popular product lines to the country, including the Jeep Wrangler and Grand Cherokee. Tesla (TSLA) should benefit materially as well as the company had planned to absorb the negative impact of the higher tariff in an effort to keep its cars affordable in the Chinese market. The electric vehicle manufacturer has decided to cut prices on certain models to stoke demand.

Worth noting, however, is the potential for a response of the reduction of tariffs in the opposite direction, or imports from China to the US, should China follow through with its proposal. GM would be a notable beneficiary of this action as it produces multiple vehicles in China for the US market, including certain Buick and Cadillac models. Among those models is the Buick Envision, which was estimated at ~19% of total Buick sales in the US in 2017 (Buick accounted for just over 7% of total GM unit sales in 2017). Ford had also reportedly been planning on importing its new cross over, the Focus Active, from China to the US, but the prior increase in tariffs stalled those plans.

All things considered, the potential de-escalation of trade tensions between the US and China should benefit the auto space as a whole as well as improve sentiment in other areas impacted by the ongoing trade dispute, though there is still a long and winding road ahead in terms of meaningful long-term solutions. We continue to highlight GM as our favorite automaker, due in part to its strength in China relative to rivals, and the idea is currently included in both simulated newsletter portfolios. We currently value shares of GM at $54 each, and the company's adjusted Dividend Cushion ratio, which reduces the impact of financial-related debt, of 3.4 pairs nicely with a dividend yield of nearly 4.3% as of this writing.

Repub: Johnson & Johnson's Litigation Risk Manageable

This article was previously published June 6, 2018.

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

By Brian Nelson, CFA

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

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

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

We simply cannot handicap the outcome of thousands of jury trials, but we think if J&J is found liable for damages, it's likely it may amount to a few million dollars in each case, on average. The range of outcomes, however, is still rather large. In a verdict in April and another in May, damages were pegged at $37 million and ~$22 million, respectively. Just for perspective, and just to give an idea of how to think about one-time legal settlements in the context of equity valuation, let's throw out a few numbers. If we assume J&J loses half of its cases, but it is able to reduce the verdicts for the cases it loses to an average ~$5 million settlement, J&J could be on the hook for $16.5 billion (3,300 cases x $5 million). If we assume J&J loses all its outstanding cases at ~$10 million per settlement, on average, the company could be on the hook for $66 billion (6,600 cases x $10 million).

J&J's market capitalization is ~$330 billion at the time of this writing, so we're talking about a 5% baseline one-time impact to equity value under the first scenario and a 20% impact in the more-punitive latter scenario. It's probably most likely that any legal fees end up somewhere between these two numbers ($16.5-$60 billion), but again, the answer is unknowable at this time, and only presented

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if we had to peg an estimate. J&J's share price has fallen 15%-20% since the peak in early January this year, and while broader market concerns aided in the weakness, to a large degree, we think risks related to talcum powder products are already largely factored in, under the two reasonable base-case scenarios we've outlined.

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

Costco Sinks on Margin Pressures

By Kris Rosemann

Shares of bulk food retailer Costco Wholesale (COST) faced material selling pressure following the release of its fiscal 2019 first quarter report December 14 as concerns over margin pressures outweighed its impressive top-line growth. Total company comparable sales, adjusted for changes in gasoline prices, foreign exchange rates and revenue recognition changes, grew 7.5% on a year-over-year basis in the quarter, and e-commerce sales leapt 26.2%. The company's US operations led the way with 8.3% comparable sales growth, and total revenue advanced 10.2% from the year-ago period.

Despite the impressive top-line growth, Costco's GAAP operating income was roughly flat in the quarter from the comparable period of fiscal 2018 at $949 million. Higher merchandise costs as a percentage of revenue were the key driver for the company's GAAP operating margin to contract nearly three percentage points from the year-ago period to 27%. Management noted that an increase in competition on the fresh side of its business from both supermarkets and Sam's Club (WMT) has been present in the past few quarters and is impacting margin performance. GAAP earnings per diluted share jumped to $1.73 in the quarter from $1.45 in the first quarter of fiscal 2018 thanks in large part to a materially lower tax bill.

We currently value shares of Costco at $187 each, and we're not looking to add exposure to the company at this juncture, though we do admire the business. It has a number of strengths: strong member renewals, fantastic employees that enjoy the higher-than-average pay, great merchandise, and a treasure-hunt atmosphere that consumers love. Its image speaks of quality, and the public often uses Costco as an example for excellent employee relations. Costco targets merchandise that produces high sales volumes and rapid inventory turnover. This turnover, when combined with efficiencies achieved by volume purchasing, efficient distribution and reduced handling of merchandise in no-frills, self-service warehouses, enables Costco to operate profitably at significantly lower gross margins than peers.

The company doesn't offer a very competitive dividend yield, which sits at less than 1.1% as of this writing, but it has paid multiple massive special dividends of $7 per share, $5 per share, and $7 per share in special dividends in fiscal years 2013, 2015, and 2017, respectively, all of which drastically overshadow its current annual per share dividend of $2.28. Costco's Dividend Cushion is an impressive 2.7 thanks to solid free cash flow generation (averaged ~$2.6 billion in fiscal 2016-2018 compared to annual run rate dividend obligations of $689 million) and a net cash position of $772 million at the end of fiscal 2018, but the measure does benefit from relatively low dividend obligations.

In the News...

By Kris Rosemann

OPEC and its allies have reportedly agreed to cut crude oil (USO) production by 1.2 million barrels per day from October production levels as the baseline. The agreement will last for six months and will be reviewed once again in April. OPEC member nations, with the exception of Iran, Libya, and Venezuela, will lower output by 800,000 barrels per day, while Russia and other allies will reduce production by 400,000 barrels per day. The production cut agreement comes shortly after news broke that the US became a net exporter of oil for the first time since the Department of Energy was formed in 1973 in the week ending November 30.

Simulated newsletter portfolio idea Altria (MO) has pulled the trigger on breaking into the marijuana market with an agreement to take a 45% stake in Cronos Group (CRON), a leading global cannabinoid company based in Toronto. The deal is valued at ~$1.8 billion and will include a warrant to acquire additional ownership of up to 55% in full in addition to the right to nominate four directors to Cronos' board. It also raises an interesting question as to whether some sort of collaboration may ultimately be in the works should Altria continue its reported pursuit of privately-held e-cigarette maker Juul.

The agreement will allow Altria to take part in the emerging cannabis sector and creates a significant growth opportunity in an adjacent business that should be complementary to its core tobacco business, which has been suffering from volume declines for some time now as the number of smokers in the US recently hit a record low. Such a deal was viewed as inevitable by many and appears to be a natural extension of the tobacco business as the legalization of marijuana for recreational use continues to gain steam across the US with Michigan the most recent state to approve such use. Cronos should benefit materially from Altria's scale and expertise in areas such as intellectual property development, regulatory science, government affairs, compliance, and brand management. We are of the opinion that the marijuana market will continue to be shaped in a meaningful way by inevitable regulatory hurdles, and growth may very well not be unfettered in that regard.

Price fixing of generic drugs broke into the news as an antitrust lawsuit over just two drugs in late 2016, but the investigation now reportedly involves at least 16 companies and 300 drugs. The generic drug industry is one that has been lauded as a potential savior of rampant healthcare costs in the US, but Joseph Nielsen, an assistant attorney general and antitrust investigator in Connecticut, used evidence such as the volume of drugs and number of companies involved in supporting his claim that this may be the largest cartel in the history of the US. Teva Pharmaceuticals (TEVA), Mylan (MYL), Dr. Reddy's (RDY), and Sun Pharmaceuticals Industries (SMPQY) are among the 16 companies included in the investigation. Generic drug sales totaled $104 billion in 2017 in the US, and generics account for ~90% of prescriptions written but only 23% of costs, according to the Association for Accessible Medicines.

Shares of Apple (AAPL) found a new source of selling pressure after Qualcomm (QCOM) won a preliminary order from a Chinese court banning multiple iPhone models in the country as a result of patent violations. The Fuzhou Intermediate People's Court in China, a court that banned Micron Technology (MU) from importing certain chips earlier in 2018, found that Apple violated two Qualcomm software patents regarding resizing pictures and managing applications, and the order impacts iPhones from the 6S through the X. The patents, which are separate from those in the wide-ranging legal battle between the companies, only concern software, so Apple could make changes to its software to avoid the patents and sell iPhones in the region. The Greater China region, which includes Hong Kong and Taiwan, accounts for nearly 20% of Apple's total sales as of fiscal 2018.

A number of Apple suppliers have faced tough sledding of late following guidance reductions based on weak smartphone demand or reduced orders from a large customer, which was rumored to be Apple, including Lumentum Holdings (LITE), Qorvo (QRVO), and Cirrus Logic (CRUS). We continue to include Apple as an idea in both simulated newsletter portfolios. Our fair value estimate for shares currently sits at $236 each, and the tech giant's Dividend Cushion ratio is an impressive 6.1.

Chipotle (CMG) - Page 1 of 16

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

Valuentum Retail Equity Research | Visit us at www.valuentum.com | Ratings as of 13-Dec-2018 | Data as of 3-Dec-2018

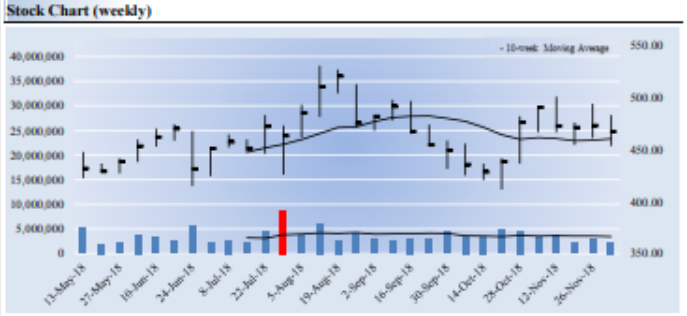
Chipotle CMG FAIRLY VALUED

Buying Index™ 6 | Value Rating

Economic Castle	Estimated Fair Value	Fair Value Range	Investment Style	Sector	Industry
Attractive	$469.00	$328.00 - $610.00	LARGE-CAP VALUE	Consumer Discretionary	Restaurants - Fast Cas & Full Svc

Chipotle is working to accelerate its high-growth online, mobile, and catering businesses, and it continues to add to its total restaurant count.

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™	MEDIUM
ValueTrend™	NEGATIVE
Cash Flow Generation	STRONG
Financial Leverage	LOW
Growth	MODEST
Technical Evaluation	BULLISH
Relative Strength	NEUTRAL
Money Flow Index (MFI)	NEUTRAL
Upside/Downside Volume (U/D)	BEARISH
Near-term Technical Support, 10-week MA	460.00

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)	$13,350
Avg Weekly Vol (30 wks)	3,604
30-week Range (USD)	411.55 - 530.68
Valuentum Sector	Consumer Discretionary
5-week Return	-2.0%
13-week Return	-3.2%
30-week Return	9.4%
Dividend Yield %	0.0%
Dividends per Share	0.00
Forward Dividend Payout Ratio	0.0%
Est. Normal Diluted EPS	18.71
P/E on Est. Normal Diluted EPS	25.0
Est. Normal EBITDA	887
Forward EV/EBITDA	25.5
EV/Est. Normal EBITDA	14.5
Forward Revenue Growth (5-yr)	7.9%
Forward EPS Growth (5-yr)	38.5%

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

Investment Highlights

• Chipotle serves a focused menu of burritos, tacos, burrito bowls (a burrito without the tortilla) and salads, made using fresh ingredients. It prides itself on trying to find the highest-quality ingredients ('Food With Integrity') and providing an exceptional restaurant experience. The company was founded in 1993 and is based in Denver, Colorado.

• Chipotle continues to expand its restaurant count. As of the end of the third quarter of 2018, the firm's total restaurant count was 2,463, and it expects to add 140-155 new restaurants in 2019. The company is also working to accelerate its high-growth online, mobile, and catering businesses.

• Chipotle has been on a rollercoaster ride in the past few years--beginning with the food safety scandal that caused substantial drops in same-store sales beginning in late 2015--and the restaurant is facing strengthening competition from Yum! Brands' Taco Bell, which lost its CEO to Chipotle, and Qdoba. Though top-line growth is back on track, the trajectory of menu price hikes has been disrupted by negative headlines.

• Chipotle is a fantastic company and a great concept with tons of potential growth ahead of it. However, consumer confidence was shattered in the wake of food safety issues. We think Chipotle has righted the ship, but consumers will likely keep the company on a short leash when it comes to public safety or satisfaction concerns.

• Investors should be aware of the generosity in our assumptions. Not only are we expecting mid- to high-single digit revenue growth through 2022, but we assume significant operating margin expansion over the period. Achieving these will be an uphill climb, but are not unrealistic for the reinvigorated company.

Relative Valuation

	Forward P/E	PEG	Price / FV
Brinker	13.0	1.3	115.1%
Cheesecake Factory	18.6	1.0	90.0%
Cracker Barrel	18.7	2.1	107.5%
Darden Restaurants	18.4	2.6	108.1%
Peer Median	18.5	1.7	107.8%
Chipotle	**54.3**	**2.0**	**99.7%**

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

Returns Summary — 3-year Historical Average

Return on Equity	12.3%
Return on Assets	9.2%
ROIC, with goodwill	28.4%
ROIC, without goodwill	28.9%

ROIC = Return on Invested Capital; NMF = Not Meaningful

Financial Summary

	----- Actual -----		Projected
Fiscal Year End:	Dec-16	Dec-17	Dec-18
Revenue	3,904	4,476	4,830
Revenue, YoY%	-13.3%	14.7%	7.9%
Operating Income	58	284	327
Operating Margin %	1.5%	6.3%	6.8%
Net Income	23	176	241
Net Income Margin %	0.6%	3.9%	5.0%
Diluted EPS	0.77	6.17	8.61
Diluted EPS, YoY %	NMF	NMF	39.4%
Free Cash Flow (CFO-capex)	90	250	215
Free Cash Flow Margin %	2.3%	5.6%	4.5%

In Millions of USD (except for per share items)

Leverage, Coverage, and Liquidity

In Millions of USD

Total Debt	0
Net Debt	-509
Total Debt/EBITDA	0.0
Net Debt/EBITDA	NMF
EBITDA/Interest	Excellent
Current Ratio	1.9
Quick Ratio	1.7

NMF = Not Meaningful

Structure of the Restaurants Industry - Fast Casual & Full Service — NEUTRAL

The restaurant industry has benefited from a long-term trend toward eating out, but the space has become increasingly more competitive as new concepts are introduced and successful chains expand. Not only are there pricing pressures and trade-down threats, but rising costs for commodities and labor have pressured profits. Barriers to entry are low, and many constituents have a difficult time differentiating themselves. We tend to like larger chains that benefit from scale advantages and international expansion opportunities, though niche franchises can be appealing. We're neutral on the structure of the group.

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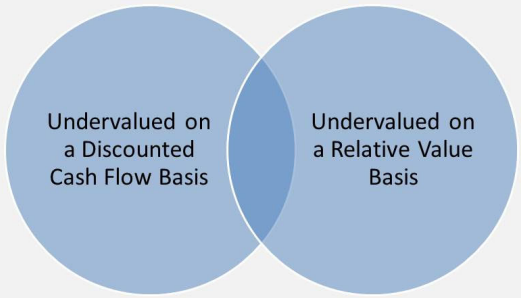
The Watch List

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	P/FV	Fair Value Estimate
General Motors	GM	UNDERVALUED	NEUTRAL	0.70	$54.00
Discover Financial	DFS	UNDERVALUED	UNATTRACTIVE	0.76	$102.00
Tupperware	TUP	UNDERVALUED	NEUTRAL	0.65	$47.00
AIG	AIG	UNDERVALUED	ATTRACTIVE	0.78	$69.00
Alibaba	BABA	UNDERVALUED	NEUTRAL	0.68	$212.00
Alphabet	GOOG	UNDERVALUED	ATTRACTIVE	0.67	$1529.00
Facebook	FB	UNDERVALUED	ATTRACTIVE	0.67	$229.00
Sohu.com	SOHU	UNDERVALUED	UNATTRACTIVE	0.63	$32.00
Michael Kors Hldg	KORS	UNDERVALUED	ATTRACTIVE	0.63	$64.00
Celgene	CELG	UNDERVALUED	ATTRACTIVE	0.60	$112.00
Gilead Sciences	GILD	UNDERVALUED	UNATTRACTIVE	0.72	$92.00
Thor	THO	UNDERVALUED	NEUTRAL	0.68	$99.00
Applied Materials	AMAT	UNDERVALUED	NEUTRAL	0.71	$50.00

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, there are no stocks that register a 9 or 10 on the Valuentum Buying Index rating system at this time. **Please consult the Best Ideas Newsletter portfolio on page 8 for our best ideas.**

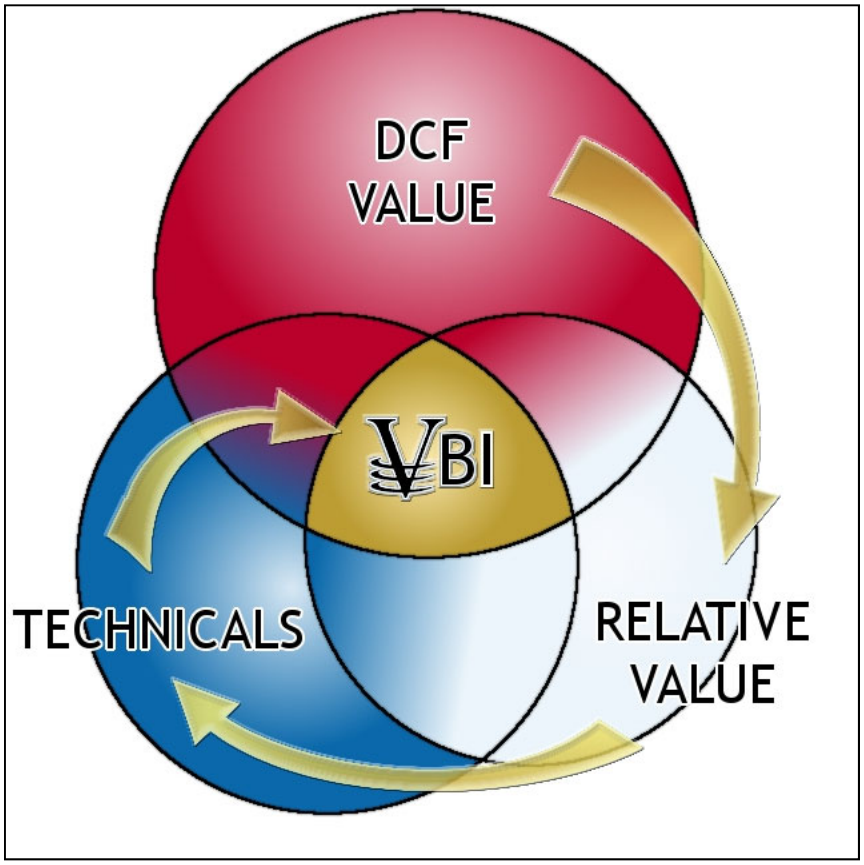
Company Name	Symbol	Industry	VBI
HEICO	HEI	A&D Suppliers	1
Cintas Corp	CTAS	Commercial Services	1
Badger Meter	BMI	Electrical Equipment	1
Arch Capital	ACGL	Insurance - Property & Casualty	1
Flowserve	FLS	Machinery & Tools	1
Graco	GGG	Machinery & Tools	1
IDEX	IEX	Machinery & Tools	1
McGrath	MGRC	Rental and Leasing	1
Corning	GLW	Electronic Suppliers	2
Dolby	DLB	Electronic Suppliers	2
Clean Harbors	CLH	Environmental Services	2
US Ecology	ECOL	Environmental Services	2
Bottomline Tech	EPAY	Financial Tech Services	2
Lancaster Colony	LANC	Food Products	2
MBIA Inc	MBI	Insurance - Property & Casualty	2
Selective Insurance	SIGI	Insurance - Property & Casualty	2
Tetra Tech	TTEK	IT Services	2
Norfolk Southern	NSC	Railroads	2
Allete	ALE	Utilities	2
Sempra Energy	SRE	Utilities	2
South Jersey	SJI	Utilities	2
Consolidated Edison	ED	Utilities - Large	2
ONEOK	OKE	Utilities - Large	2

Our Methodology – The Valuentum Buying Index (VBI)

By Valuentum Analysts

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

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



Our Methodology – The Valuentum Buying Index continued on next page

Our Methodology – The Valuentum Buying Index continued from previous page

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

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

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

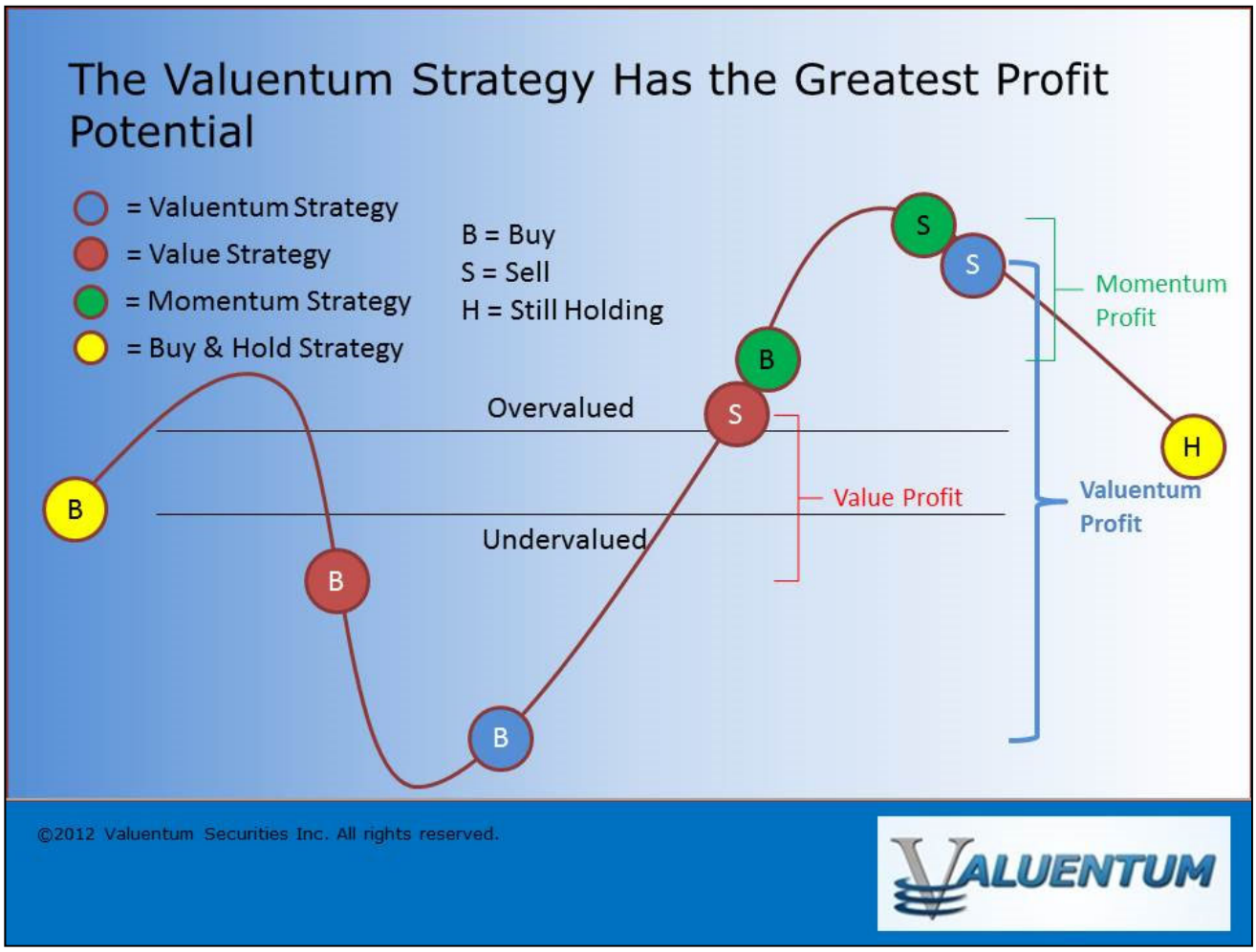


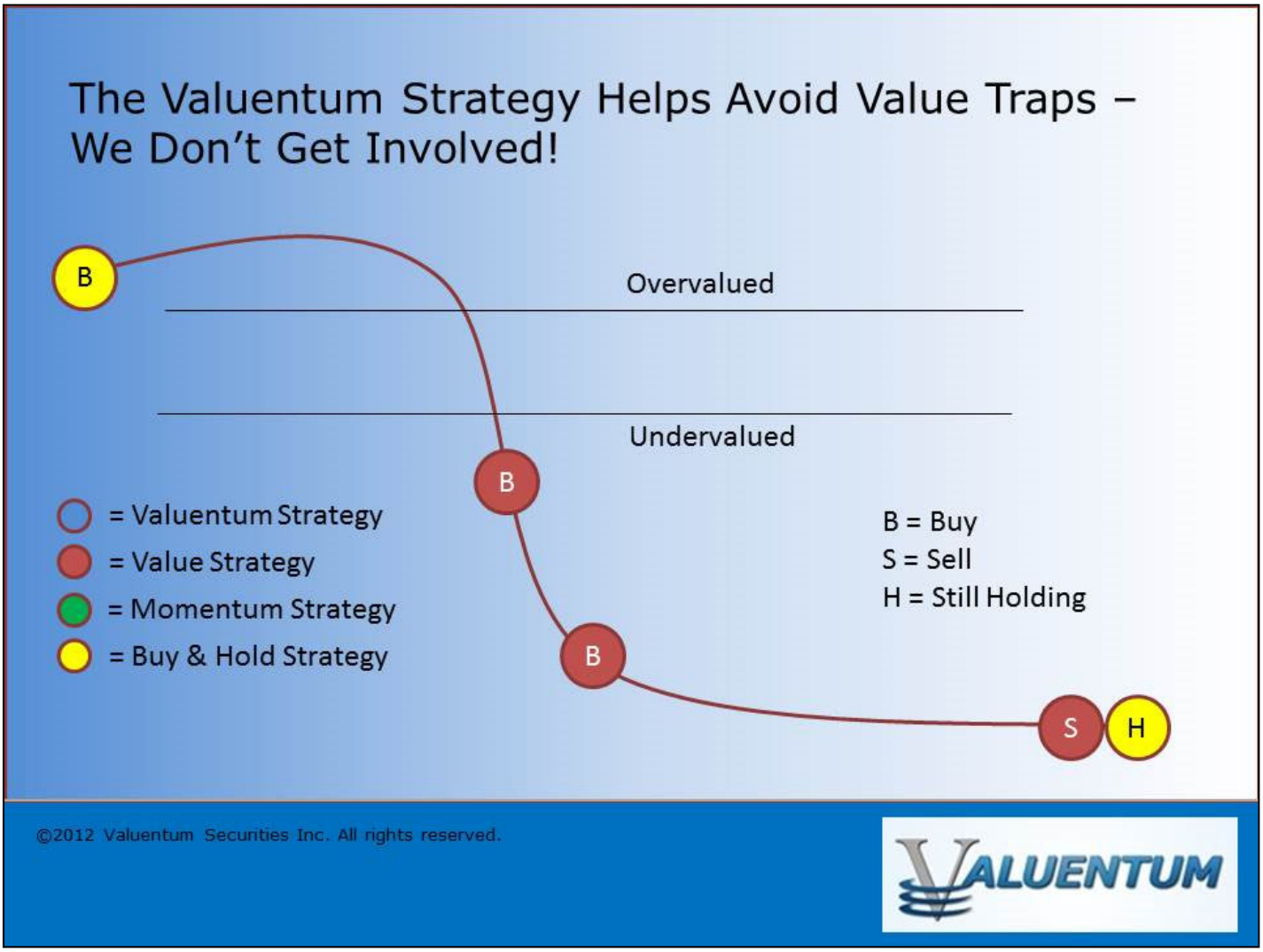
Illustration for educational purposes only.

Our Methodology – The Valuentum Buying Index continued on next page

Our Methodology – The Valuentum Buying Index continued from previous page

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

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



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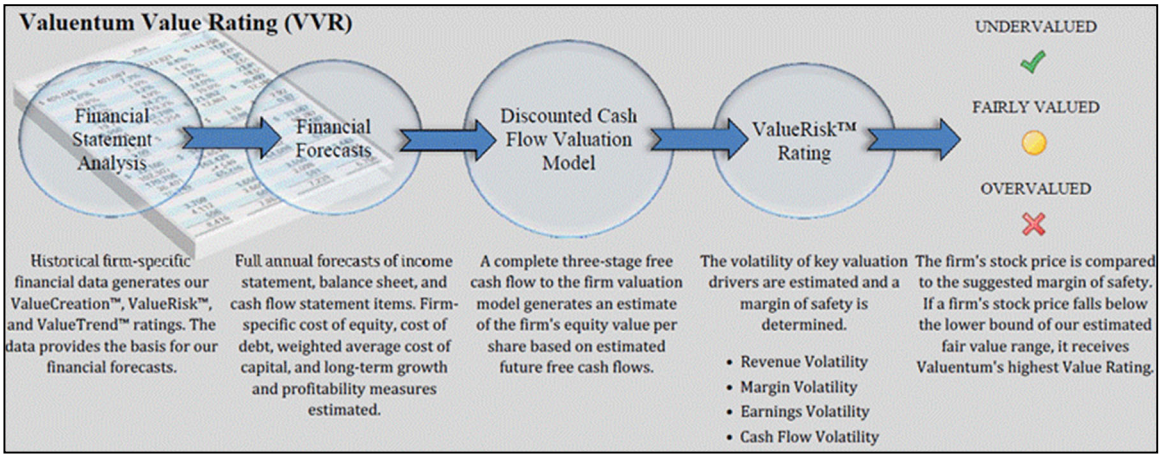
Our Methodology – The Valuentum Buying Index continued on next page

Our Methodology – The Valuentum Buying Index continued from previous page

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

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

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



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

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

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

Our Methodology – The Valuentum Buying Index continued on next page

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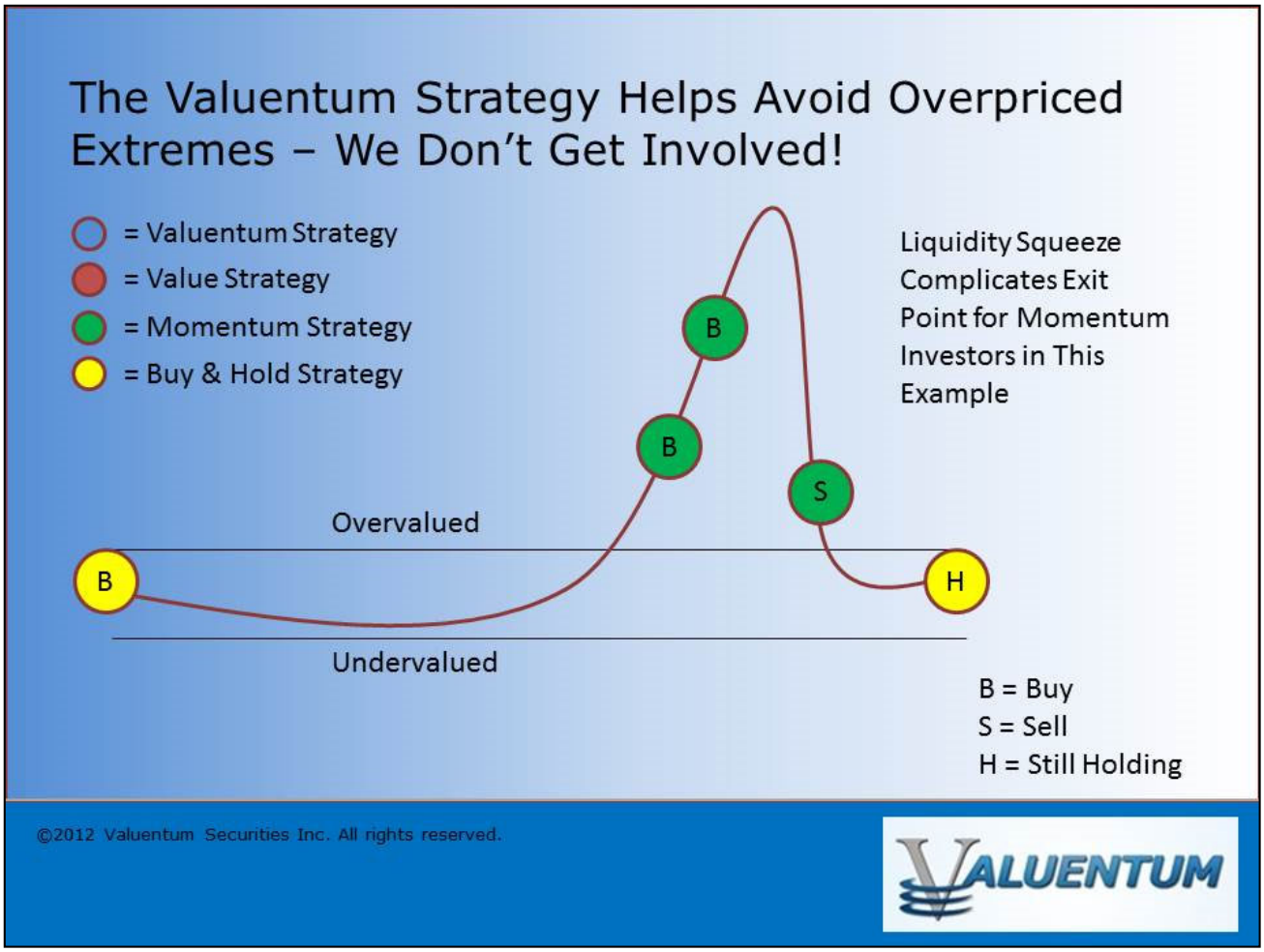

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II. The Valuentum Buying Index Incorporates A Forward-Looking Relative Value Assessment

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

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

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

Our Methodology – The Valuentum Buying Index continued on next page

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valuation criteria).

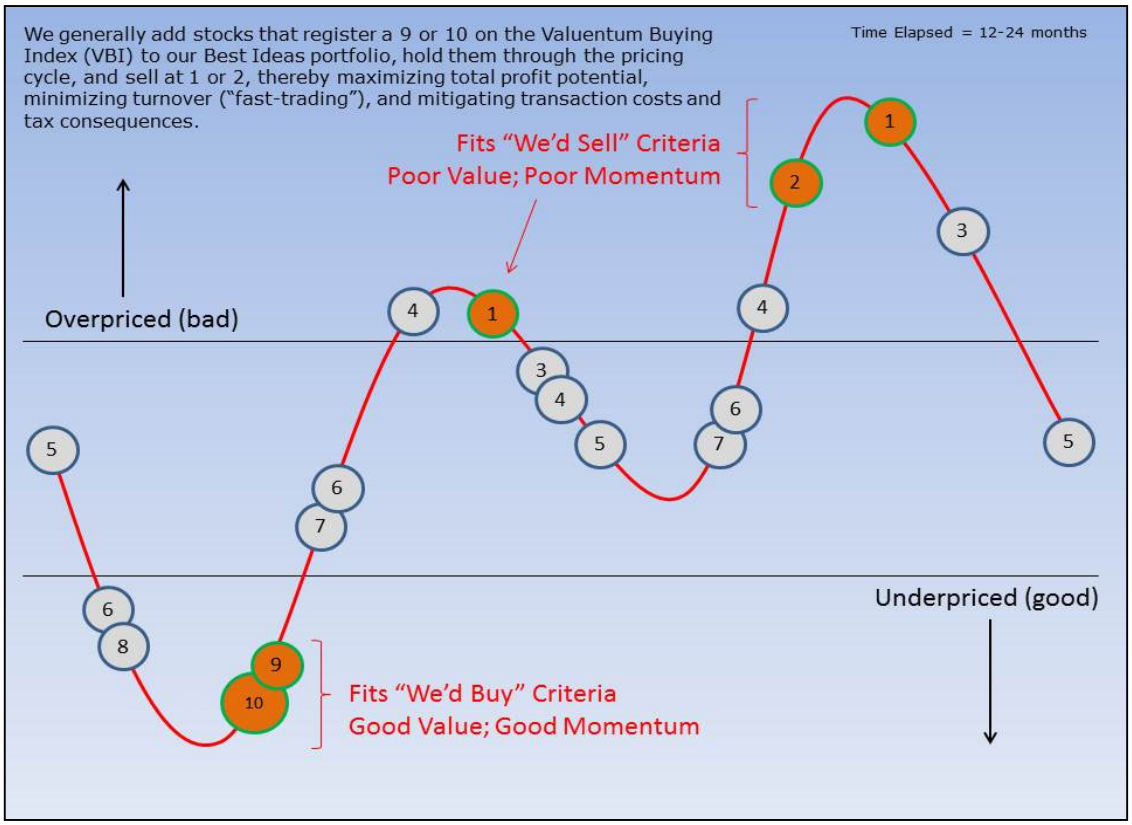
Rigorous valuation analysis and technical analysis are not mutually exclusive, and we believe both can be used together to bolster idea generation. An evaluation of a stock's moving averages, relative strength, upside-downside volume, and money flow index are but a few considerations we look at with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

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

Putting It All Together - the Valuentum Buying Index

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

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



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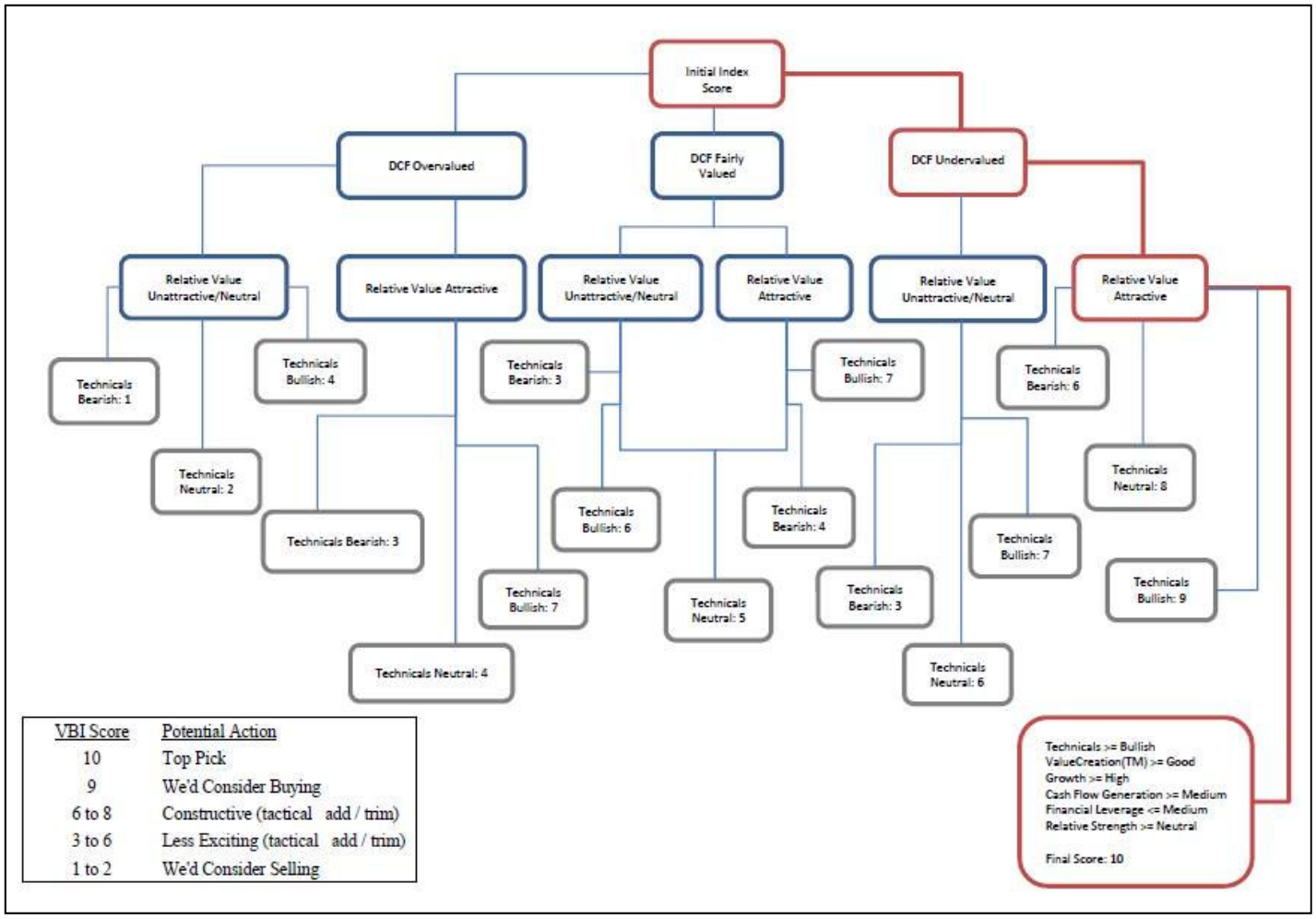
Let's follow the red line on the flow chart below to see how a firm can score a 10, the best mark on the Valuentum Buying Index (a "Top Pick"). Please click here to view an enlarged pdf version.

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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Our Methodology – The Valuentum Buying Index continued on next page

About the Fair Value Range

By Valuentum Analysts

Understanding the Fair Value Range and Why It's Important

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

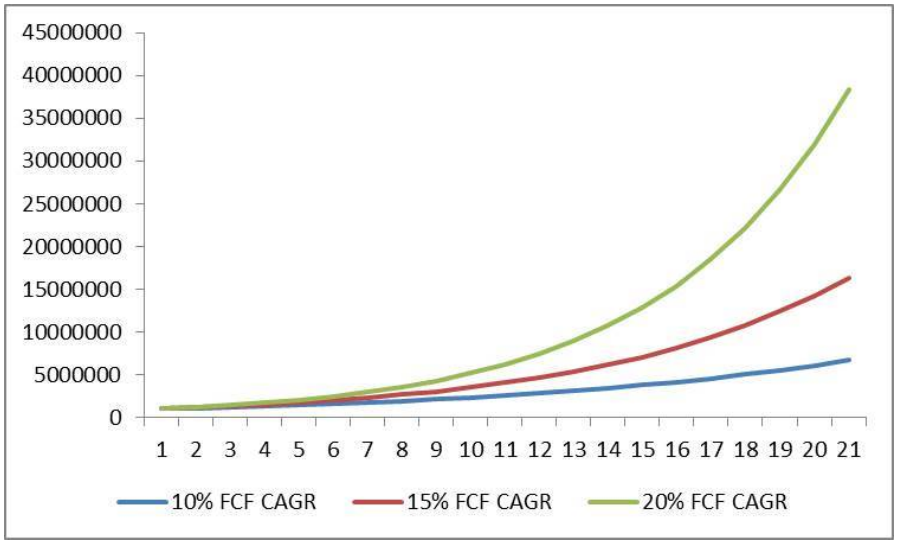
One of the most important concepts of the Valuentum methodology (and valuation in general) is the understanding that the value of a company is a range of probable valuation outcomes, not a single point estimate. Even well-seasoned stock analysts are guilty of saying that a company's shares are worth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

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

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

But why the large range in many cases?

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



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

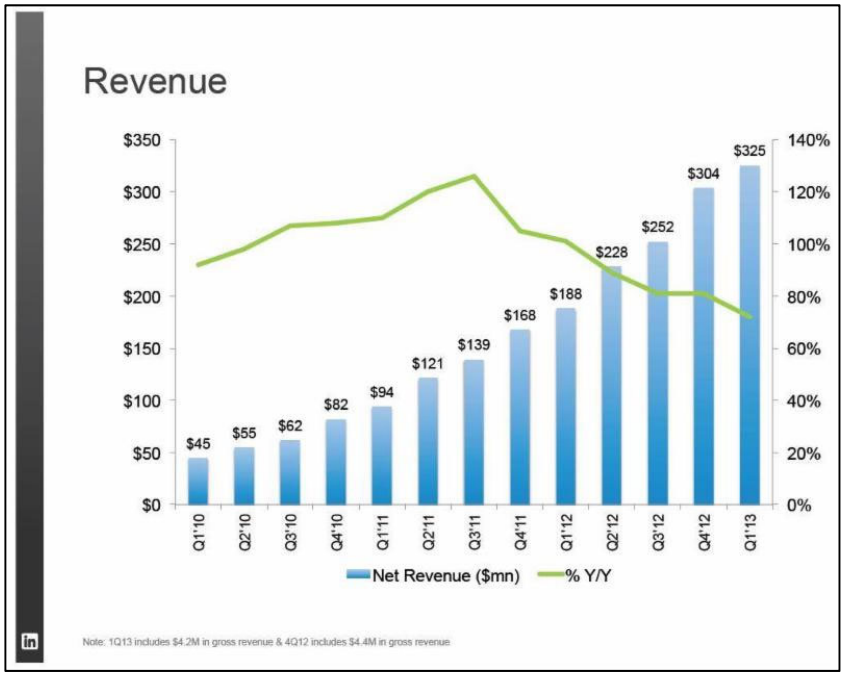

Image Source: LinkedIn

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

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

Shares collapsed in a huge way.

About the Fair Value Range continued on next page

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

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

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

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

By Valuentum Analysts

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

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

The Valuentum Buying Index Has Checks and Balances

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

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

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

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

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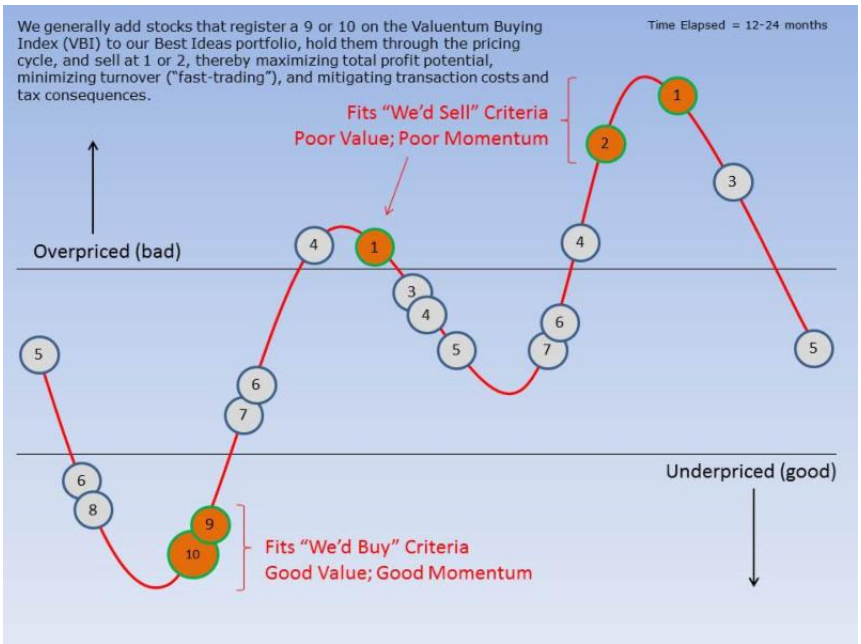
may be the secret to success in investing, a lot could have gone wrong with the temptation to do something each day. Obviously, we're very disciplined, but we also credit the portfolio outperformance to the VBI methodology itself. It is a very helpful tool.

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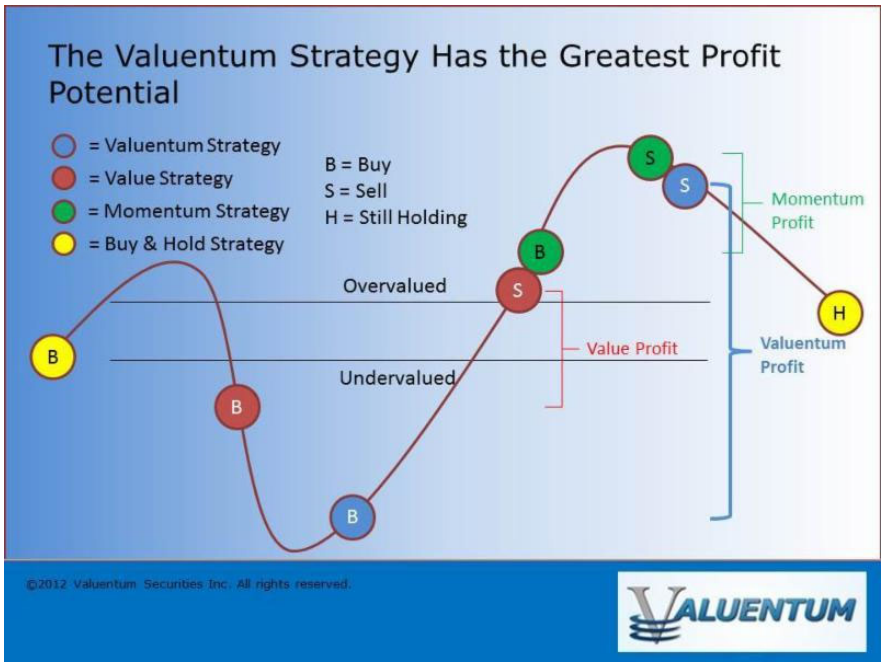
But why don't we churn our ideas by updating daily and trading a lot? Obviously, we don't think that's the secret to investment success. In quite the opposite approach, we strive to maximize profits on every idea that we pursue, with the understanding that momentum does exist and that prices over and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

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