OUR BEST IDEAS NEWSLETTER

Valuentum Securities

Stock Analysis: From Value through Momentum Investing

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Valuentum Securities Inc.
www.valuentum.com info@valuentum.com

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

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"We're expecting stock market volatility to increase in the coming years, and our finger remains on the put-option trigger as the uncertainty of the political environment and Fed policy may only increase as we head into the back half of 2019."

– Brian Nelson, CFA

Changes to the Simulated Best Ideas Newsletter Portfolio

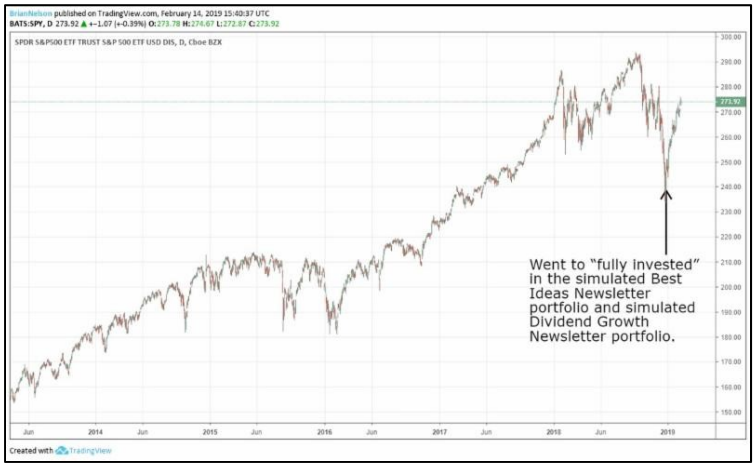

Image shown: In our December 26 note to members, we moved the simulated Best Ideas Newsletter portfolio to "fully invested" from a cash "allocation" of 30% at the high end of the range. It has worked out wonderfully as we keep our finger on the put option trigger in case price-agnostic trading and heightened volatility rears its ugly ahead again, as it did in December 2018.

Summary of Changes to the simulated Best Ideas Newsletter Portfolio:

Remove *Gilead Sciences (GILD)*

Add *Financial Select Sector SPDR ETF (XLF) at 2.5%-4% weighting*

By Kris Rosemann and Brian Nelson, CFA

Let's walk through some news before we talk about the changes to the Best Ideas Newsletter portfolio. First, the Dividend Cushion ratio has done it again, highlighting the risk of a dividend cut at CenturyLink (CTL) before it disappointed income investors again. The company's Dividend Cushion ratio was an ominous -3.3 (negative 3.3) before it slashed it. Remember -- because the Dividend Cushion ratio maps future expected free cash flows with future expected dividends expected to be

*Changes to the Simulated...*continued on next page

Brian M. Nelson, CFA
President, Equity Research
brian@valuentum.com

Kris Rosemann
Head of Data, Associate Analyst
kris@valuentum.com

Christopher Araos
Associate Stock and Dividend Analyst

Callum Turcan
Independent Energy Contributor

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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paid in the context of net balance sheet health, it highlights the overall risk of a dividend cut (ratios well below 0 = very risky), as much as the capacity for dividend growth (ratios significantly above 1 = less risky).

Also, just a heads up. Facebook (FB) and Alphabet (GOOG, GOOGL) no longer register 10s on the Valuentum Buying Index, but that is no cause for alarm. [Their new VBI ratings are reflected in their stock reports and will be updated in their respected stock tables with the website refresh this weekend.] We pay utmost attention to the price-versus-estimated fair value ratio, and we use the Valuentum Buying Index as a way to improve our "entry" and "exit" points on undervalued ideas. Since registering a 10 in January 2019, Facebook's shares have advanced roughly 15%, while Alphabet's shares increased a more-modest 4%.

In any case, once an idea is added to the simulated newsletter portfolios, there is a significant amount of criteria we consider before adjusting its "weighting" or removing it. Here are some of the intricacies:

> As it relates to the simulated Best Ideas Newsletter, for example, if a stock registers a 9 or 10 on the Valuentum Buying Index, we would consider adding it to the simulated newsletter portfolios. When the stock then/eventually registers a 1 or 2 on the Valuentum Buying Index in time, we might then consider removing it from the simulated newsletter portfolios. The changes in the "big middle" of the Valuentum Buying Index offer more tactical considerations, but we generally only consider the highest and lowest VBI ratings to be material. During times of market froth, however, as in arguably today's environment, in the simulated Best Ideas Newsletter portfolio, we may relax some of the VBI criteria and consider undervalued stocks with neutral technical/momentum indicators, or fairly valued stocks with good relative valuation metrics and strong technical/momentum indicators. We may only consider removing ideas from the simulated newsletter portfolios when both their valuation and technical/momentum indicators point in the same direction (good/good or poor/poor), or if we're making more strategic/tactical moves.
>
> The way to think about our process is rather simple. In the simulated Best Ideas Newsletter portfolio, if a company registers a high rating in our coverage universe, we consider adding it (but we won't consider adding all companies because of portfolio constraints). If we do decide to add the idea, then we watch its fair value estimate and technical/momentum indicators as it navigates the "big middle" of VBI ratings, and only consider removing the idea from the simulated Best Ideas Newsletter portfolio if it registers a 1 or 2 on the Valuentum Buying Index.

Let's discuss the changes to the newsletter portfolio.

Gilead Sciences has come back to bite us again, and we're removing the idea from both the Best Ideas Newsletter portfolio. This idea was highlighted in July 2017 in the $76 range, but the story simply has not panned out as its strength in the HIV market has not offset significant weakness in HCV and its diversified pipeline has disappointed. The most recent disappointment came February 11 when a highly anticipated Phase 3 clinical trial of its NASH treatment solensertib failed to meet its primary endpoint. We've been counting on some big news in its pipeline.

The global NASH (nonalcoholic steatohepatitis) drug market is estimated at $35 billion, and the National Institutes of Health estimates that as high as 12% of US adults are afflicted by the fatty liver disease. There is currently no FDA-approved treatment available, and a number of pharma companies are racing to be first to market, which is what makes Gilead's disappointing result all the more painful.

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Gilead's recent acquisition of Kite Pharma was targeted at expanding its product pipeline into the rapidly-growing area of oncology, and it has high hopes for recently-launched Yescarta. However, an impairment charge in the fourth quarter of 2018 related to a multiple myeloma drug being developed by Kite highlights the difficulties the company is having advancing other treatments acquired in the deal. We're just not seeing too much upside potential given its recent pipeline disappointments.

To retain "fully invested" status in both the Best Ideas Newsletter portfolio, we're adding exposure to the banking space, which was previously lacking, in the simulated newsletter portfolio at the lowest weighting range via the Financial Select Sector SPDR ETF. The Fed's notably more dovish commentary (see our email to members here) adds to the attractiveness of adding exposure to the banking sector, and considering diversified exposure helps protect against the opaqueness of any one banking entity's balance sheet. The XLF currently has a dividend yield of ~1.9%, which is suppressed in part by it listing Berkshire Hathaway (BRK.A, BRK.B) as its top holding at ~13%, but JPMorgan Chase (JPM), Bank of America (BAC), and Wells Fargo (WFC) are all 5%+ weightings in the ETF.

That's all for now, but please be sure to stay tuned for any further updates. We're expecting stock market volatility to increase in the coming years (read *Value Trap*), and our finger remains on the put-option trigger as the uncertainty of the political environment and Fed policy may only increase as we head into the back half of 2019. Price-agnostic trading may only further exacerbate the situation.

Earnings Roundup: Amazon, Facebook, Honeywell, PayPal, Visa

Let's talk about our views on Amazon, Facebook, Honeywell, PayPal, and Visa. We think Facebook's equity offers the biggest bargain, but Visa remains our top idea, as it has been for some time. All prices, as noted by red dots, are as of February 1.

By Brian Nelson, CFA

Amazon's Shares Are Trading Below Our Fair Value Estimate But Sensitivity to Assumptions Is Great

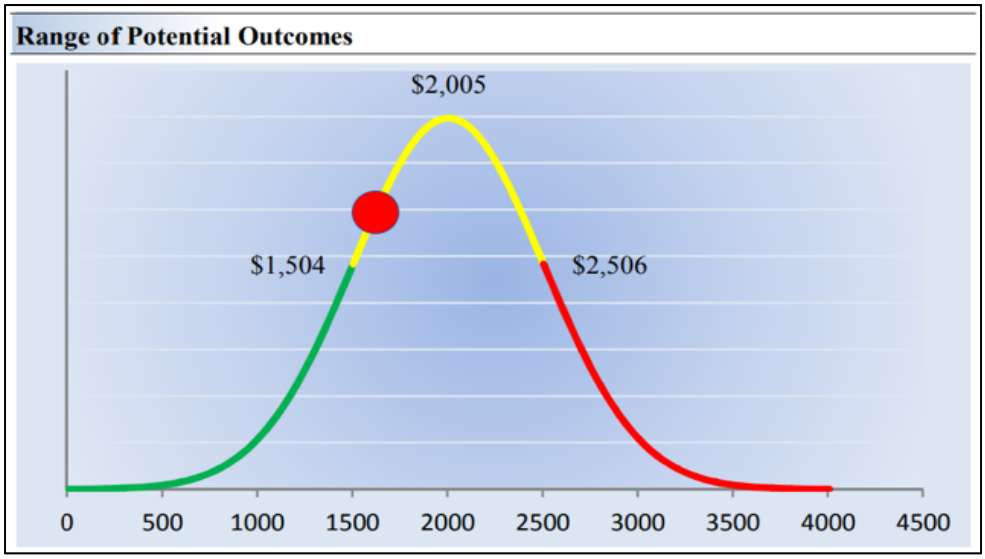

Image shown: The probability distribution of our fair value estimate range for Amazon. The company is trading below our fair value estimate of ~$2,000, but above the low end of the fair value estimate range of ~$1,500. We think shares are fairly valued if they are trading on the yellow line. Amazon's fair value estimate is very sensitive to its operating margin.

*Earnings Roundup...*continued on next page

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Here are the three things that you need to know about Amazon (AMZN). First, the company's equity value is significantly sensitive to its mid-cycle operating margin. Only a very modest change in profitability can have a large impact on our estimate of its equity value. This is primarily why we don't include the company in the simulated Best Ideas Newsletter portfolio. Even if we're wrong by just a little bit, it could mean that we're wrong by a lot when it comes to the fair value estimate. This is the nature of Amazon's business model, for better or worse. The company has tremendous earnings leverage.

Second, despite the fair-value sensitivity of its equity, Amazon has become a veritable cash-flow-generating machine. In its fourth-quarter report, released January 27, the company's free cash flow advanced to $19.4 billion for the trailing 12 months ended December 2018 compared to $8.3 billion for the trailing 12 months ended December 2017. This is extraordinary growth in a metric that matters considerably to intrinsic value. However, when it comes to valuation, it is not so much about growth as it is about growth in excess of expectations, that which causes valuation revisions. In that respect, Amazon is in-line with what we believe to be reasonable expectations.

Third, it's important you're aware of some of the news flow surrounding the name. You may have already heard about CEO Jeff Bezos' divorce, but we don't think shareholders have much to worry about from this personal event. Second, there appears to be some hiccups in Amazon's expansion efforts in India, but as with many global companies, we would expect Amazon to work with local policymakers to find an amicable solution that benefits all parties. We're focused on the long term, not on policy that may impact performance in the next few years. Finally, Amazon is making some in-roads with respect to its own advertising, and while Amazon Web Services (AWS) remains a cash-cow, the online advertising market remains robust amidst a strong economic backdrop.

Facebook's Shares Look Incredibly Cheap, Stock on the Move

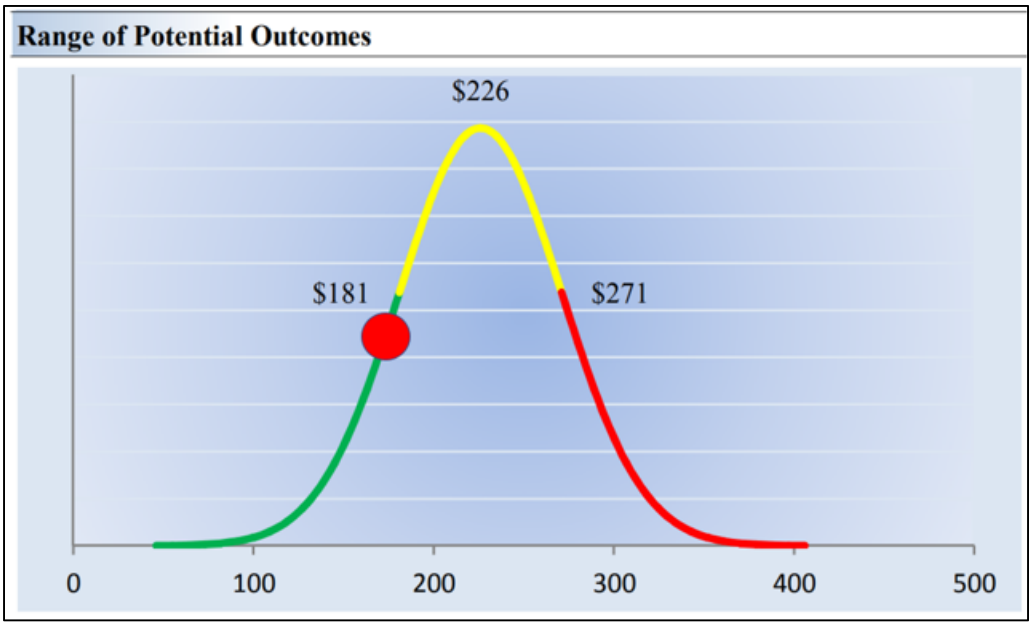

Image shown: The probability distribution of our fair value estimate range for Facebook. Very few stocks are as cheap as Facebook is today. The company continues to be beaten down by negativity surrounding how it handles consumer data, but on a cash-basis, its shares offer long-term investors a bargain, in our view.

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Not all is bad at Facebook (FB). Remember, a company's value is not sentimental. Whether you love or hate what Facebook is doing, it is cash that forms the basis of intrinsic value, whether it is net cash on the balance sheet or future expectations of enterprise free cash flows. We know Facebook has made some mistakes, but when it comes to evaluating price versus estimated intrinsic value, very few companies offer this level of a disconnect. We think shares of Facebook are extremely cheap at the moment, and our fair value estimate stands at $226 per share.

The social media behemoth reported fourth-quarter results January 30, and they certainly weren't bad by any stretch (in our opinion, they were actually quite good). Total revenue advanced 30% in the quarter on a year-over-year basis, while net income soared more than 60%. The company's operating margin came in at 46%. We're currently modeling in 20% compound annual growth on the top line and an average operating margin of ~37% over the next five years, and this is what we are using to arrive at our fair value estimate.

A range of fair value outcomes considers a scenario with respect to contingent liabilities, too. Hypothetically, even if contingent legal liabilities related to alleged data misuse amounted to a whopping $100 billion, shares of Facebook would still be cheap! The company remains 10-rated on the Valuentum Buying Index and among the top "weightings" in the simulated Best Ideas Newsletter portfolio. It's going to stay that way for some time. We think Facebook may once again challenge new highs.

Honeywell Has Great Backdrop in Aerospace, Not Too Pricey and Strong Dividend

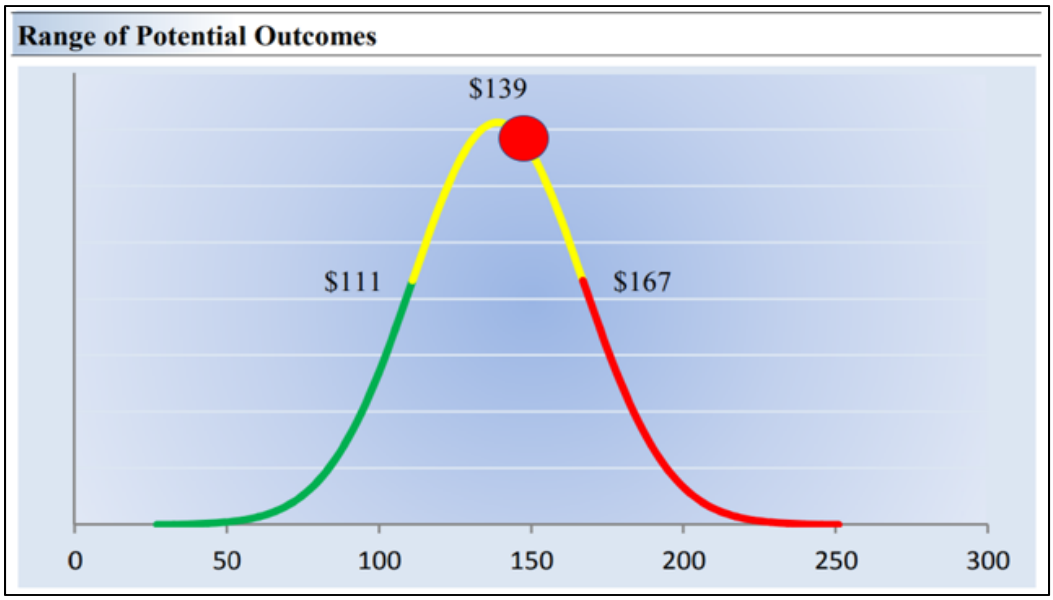

Image shown: The probability distribution of our fair value estimate range for Honeywell. Honeywell is one of our favorite industrials, now that GE has headed south. The company's aerospace exposure is fantastic, but its shares are pricing in a lot of the good news.

There's a whole bunch to like about Honeywell (HON). The company released fourth-quarter results February 1, and they had some noise in them due to spin-offs, but otherwise were quite solid. On an organic basis, revenue advanced 6%, while adjusted earnings per share leapt 12%, excluding spin-offs. For the full year, adjusted free cash flow advanced 2%, reflecting a conversion rate of 100% from net income, and management remained optimistic about sales, margin and cash flow growth in 2019 after its business transformation (it spun off Transportation Systems and its Homes and ADI Global Distribution businesses).

*Earnings Roundup...*continued on next page

*Earnings Roundup...*from previous page

We continue to be huge fans of Honeywell, particularly its long-cycle commercial businesses, namely commercial aerospace, U.S. defense, and warehouse automation. The company's commercial aerospace division is stacked with orders as the backlogs at the airframe makers Boeing (BA) and Airbus (EADSY) remain full. Honeywell's management noted that its long-cycle orders and backlog advanced 15% during 2018. We fully expect the company to capitalize on the strength of order trends, and at higher levels of profitability. Segment margin expansion is running ahead of internal targets.

Here's what the company had to say about its 2019 outlook:

> Honeywell expects sales of $36.0 billion to $36.9 billion, representing organic sales growth of 2 to 5 percent; segment margin expansion of 110 to 140 basis points, or 30 to 60 basis points excluding the favorable impact of the 2018 spin-offs; earnings per share of $7.80 to $8.10; operating cash flow of $5.9 billion to $6.5 billion and adjusted free cash flow of $5.4 billion to $6.0 billion, representing conversion of approximately 100 percent.

We are strongly considering Honeywell for addition to the simulated Dividend Growth Newsletter portfolio. Though the simulated newsletter portfolio is currently "fully invested," we could swap Honeywell with another equity should we grow even more excited about its commercial aerospace prospects, which have only grown stronger in years past. Honeywell's Dividend Cushion ratio stands at 2.3, and the company yields ~2.3% at the time of this writing. Not bad at all.

PayPal's Shares Still Have Upside In Our View

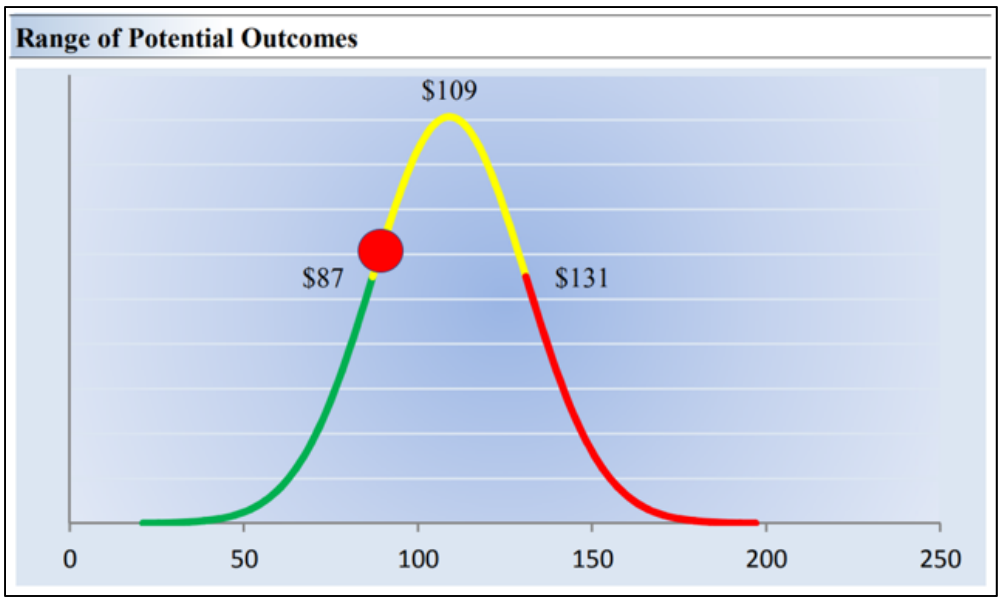

Image shown: The probability distribution of our fair value estimate range for PayPal. We continue to like shares of PayPal and view it as a stealth way to play cryptocurrency, as well as the proliferation of e-commerce, which while growing fast, still remains in its infancy around the globe.

PayPal's (PYPL) shares have come in a bit after releasing its fourth-quarter results January 30. On the whole, the performance during the quarter wasn't bad. Quarterly GAAP revenue growth didn't quite come in on par with its full-year run rate, but it still grew at a mid-teens clip (14% on a non-GAAP basis). Non-GAAP earnings per share also advanced nicely, a 26% year-over-year rate in the quarter, to $0.69. During the fourth quarter of 2018, PayPal added 13.8 million active accounts, which was significantly better than the 8.7 million it added in the same period a year ago. Payment transactions were up 28%, while

*Earnings Roundup...*continued on next page

*Earnings Roundup...*from previous page

total payment volume increased 25% on a foreign-exchange neutral basis, both year-over-year comparisons. 2018 was a solid year for PayPal.

Here's what PayPal had to say about its outlook for 2019:

> PayPal expects revenue to grow 16-17% at current spot rates and 16-17% on an FX-neutral basis, to a range of $17.85-$18.1 billion. As previously disclosed, full year 2019 revenue growth guidance includes an expected decline of approximately 3.5 percentage points for full year 2019 related to the sale of U.S. consumer credit receivables to Synchrony.
>
> PayPal expects GAAP earnings per diluted share in the range of $1.83-$1.93 and non-GAAP earnings per diluted share in the range of $2.84 - $2.91.
>
> Estimated non-GAAP amounts above for the twelve months ending December 31, 2019, reflect adjustments of approximately $1.30-$1.40 billion, primarily representing estimated stock-based compensation expense and related payroll taxes in the range of $1.05-$1.11 billion.
>
> Estimated GAAP and non-GAAP results include approximately 1.5 points of revenue growth and $0.08 to $0.10 of dilution from the acquisitions that closed in 2018.

The stock traded off as a result of its outlook for 2019, but it wasn't poor by any stretch. Revenue growth looks to be solid, and non-GAAP earnings growth is targeted at a 20% clip at the high end of the range from last year's levels ($2.42). All appears to be healthy at PayPal, and we think the company offers a compelling proposition for those seeking e-commerce exposure. We have retained the company in the simulated Best Ideas Newsletter portfolio ever since its spin-off with eBay (EBAY) some years ago.

Visa Continues to Be a Top Performer

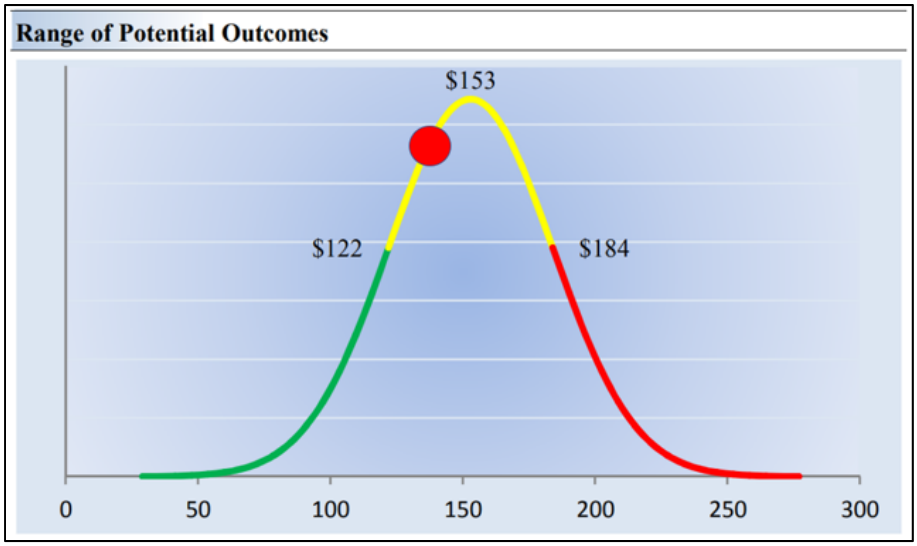

Image shown: The probability distribution of our fair value estimate range for Visa. We like Visa the most. It is our top idea, and we think 2019 is shaping up to be a fantastic year for the equity after a very strong 2018.

Visa (V), hands-down, is one of the best companies on the planet. It remains one of the "highest-weighted" equities in the simulated Best Ideas Newsletter portfolio, and its share-price performance during 2018 was simply awesome while most of the market swooned. The company offers a compelling way to play the secular trend toward a cashless society, and its operating margins are simply through the roof. If you asked us to name one company that we like the most, Visa would be it.

*Earnings Roundup...*continued on page 9

Valuentum's Best Ideas Portfolio

By Valuentum Analysts

Valuentum's BEST IDEAS -- as of February 15, 2019

Portfolio Holdings	Symbol	Div Yield %	Fair Value	Economic Castle	VBI Rating	P/FV	Last Close	% of Portfolio
Berkshire Hathaway	BRK-B	0.00%	$229.00	NA	5	0.90	205.29	7%-12%
Facebook	FB	0.00%	$226.00	Very Attractive	7	0.72	162.50	7%-12%
Alphabet - Class C	GOOG	0.00%	$1512.00	Very Attractive	7	0.74	1113.65	7%-12%
Visa	V	0.70%	$153.00	Attractive	4	0.95	144.91	7%-12%
Apple Corp.	AAPL	1.71%	$217.00	Highest Rated	6	0.79	170.42	5.5%-7%
SPDR S&P Dividend ETF	SDY	2.57%	NA	NA	UR	NMF	98.50	5.5%-7%
Energy Select SPDR	XLE	3.18%	NA	NA	UR	NMF	66.12	5.5%-7%
Health Care ETF	XLV	1.50%	NA	NA	UR	NMF	92.85	5.5%-7%
Cisco	CSCO	2.73%	$54.00	Very Attractive	3	0.92	49.43	4%-5.5%
Intel	INTC	2.48%	$56.00	Attractive	7	0.92	51.66	4%-5.5%
Johnson & Johnson	JNJ	2.68%	$137.00	Attractive	6	1.00	136.38	4%-5.5%
Booking Holdings	BKNG	0.00%	$2084.00	Highest Rated	4	0.93	1933.57	2.5%-4%
Chipotle	CMG	0.00%	$469.00	Very Attractive	6	1.29	605.89	2.5%-4%
Dollar General	DG	0.98%	$106.00	Attractive	3	1.12	119.00	2.5%-4%
Financial Select SPDR ETF	XLF	1.91%	NA	NA	UR	NMF	26.42	2.5%-4%
General Motors	GM	3.90%	$54.00	Attractive	7	0.72	39.09	2.5%-4%
PayPal	PYPL	0.00%	$109.00	Attractive	7	0.87	94.91	2.5%-4%
Verint Systems	VRNT	0.00%	$56.00	Very Attractive	3	0.94	52.39	2.5%-4%
Cash consideration	-	-	-	-	-	-	-	0.0%

UR = Under Review
This portfolio is not a real money portfolio. Data as of February 15, 2019.
We have consolidated our simulated position in Alphabet to the highest weighting to reflect our confidence in the idea.

We've taken the cash "weighting" in the simulated Best Ideas Newsletter portfolio to 0%. The midpoints of our respective weighting ranges sum to 100% to reflect the range of possible combinations that may result in this allocation.

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 simulated 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.

*Earnings Roundup...*from page 7

The credit card processing giant reported solid fiscal first-quarter results January 30 that reflected 13% top-line growth and 20% earnings-per-share expansion on a year-over-year basis, despite what management characterized as "an uncertain geopolitical environment." Payments volume leapt 11%, cross-border volume increased 7%, while processed transactions advanced more than 10%. During the quarter, management returned $2.9 billion in capital in the form of share repurchases and dividends, while the board authorized a new $8.5 billion share-repurchase program.

Here's what Visa had to say about its outlook for the remainder of fiscal 2019:

> Annual net revenue growth: Low double-digits on a nominal basis, with approximately 1 percentage point of negative foreign currency impact and de minimus impact from the new revenue accounting standard
>
> Client incentives as a percentage of gross revenues: 22% to 23% range
>
> Annual operating expense growth: Mid-single digit decrease on a GAAP basis and mid-to-high single digit increase adjusted for special items in fiscal 2018 (see note below). GAAP and non-GAAP growth includes an approximately 1.5 to 2 percentage point increase from the new revenue accounting standard
>
> Effective tax rate: 20.0% to 20.5% range
>
> Annual diluted class A common stock earnings per share growth: High teens on a GAAP nominal dollar basis and midteens on an adjusted, non-GAAP nominal dollar basis (see note below). Both include approximately 1 percentage point of negative foreign currency impact

If you haven't yet considered Visa as an idea, it is one of our favorites--and has been for years. Its business model is just too difficult to pass up, in our view. Visa gets paid every time someone swipes one of their cards, and it doesn't take on the credit risk of its customers, unlike American Express (AXP) and Discover (DFS). We continue to see upside to Visa on the basis of our fair value estimate.

Alphabet Working to Balance Rising Spending and Driving Revenue Growth

Alphabet's top-line growth remains impressive, but rising costs continue to pressure margin performance. Free cash flow generation is still robust, which provides the backbone for its fortress-like balance sheet, but capital spending levels advanced at a significant rate in 2018.

By Kris Rosemann

Simulated Best Ideas Newsletter portfolio idea Alphabet (GOOG, GOOGL) turned in a strong finish to 2018, but rising mobile-driven traffic acquisition costs are expected to continue weighing on margin performance. Revenue at Alphabet in the fourth quarter, results released February 4, jumped 22% on a year-over-year basis as reported thanks to its continued strength in Mobile Search as well as support from YouTube, Cloud, and Desktop Search, but operating income growth came in at only ~7% as its GAAP operating margin fell to ~20.9% from 23.7% in the year-ago period.

Total cost of revenues advanced 26% on a year-over-year basis, driven by content acquisition costs for YouTube, including for advertising supported content and its new subscriptions business, the latter of which carrier higher content acquisition costs as a percentage of revenue. Costs related to data centers and hardware costs for Google and Nest family products also added to cost of revenue growth.

*Alphabet Working to Balance...*continued on next page

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Total traffic acquisition costs (TAC) rose 15% on a year-over-year basis, and total traffic acquisition costs as a percentage of advertising revenue fell roughly one percentage point from the year-ago period to ~23%. The rate of year-over-year growth of its TAC, which are being driven higher by strong revenue growth in the higher TAC carrying mobile search business, has slowed since the first quarter of 2018, but the ongoing secular shift to mobile search will continue to drive TAC higher.

Management is working to optimize its operating expenses to help deal with potential gross margin pressures, but it continues to invest heavily in R&D via a continually rising headcount to support growth and innovation with engineers and product managers at Google and in its Cloud business. A growing sales and marketing headcount for Cloud and Advertising contributed to rising operating expenses, as did higher advertising investments in Search and Google Assistant. Alphabet's 'Other Bets' segment continues to provide a drag on the operating line as well as it reported an operating loss of more than $1.3 billion in the fourth quarter compared to an operating loss of $748 million in the comparable period of 2017.

Nevertheless, the company is a veritable free cash flow generating machine, and management expects capital spending growth rates to moderate considerably in 2019 after nearly doubling in 2018. Despite capex jumping to more than $25.1 billion in 2018 from nearly $13.2 in 2017, free cash flow generation in the year fell by just over 4% on a year-over-year basis to $22.8 billion thanks to a 29% jump in cash flow from operations. Another robust year of free cash flow generation drove Alphabet's net cash position even higher, as it checked in at more than $105 billion at the end of 2018 ($109.1 billion in cash and $4 billion in total debt), which does not take into consideration another ~$13.9 billion in non-marketable securities.

This tremendous free cash flow generating capacity and fortress-like balance sheet, along with Alphabet's dominance in search and strong position in digital advertising, are core pillars of the company's compelling story. Amazon (AMZN) continues to grab headlines with its relatively young and rapidly-growing advertising services revenue, but Alphabet and fellow simulated Best Ideas Newsletter portfolio idea Facebook (FB), which turned in 30% year-over-year revenue growth in the fourth quarter, continue to see their already substantial advertising revenues march higher at strong double-digit rates. The fourth quarter of 2018 marked Alphabet's sixth consecutive quarter of 20%+ growth in advertising revenue, though it just made it to the mark in the period.

This is not to say that we are taking the potential for Amazon to have a more meaningful presence in the digital advertising market lightly, but we continue to be impressed by Alphabet's ability to continually deliver 20%+ growth rates in its advertising business, which is at $130+ billion in annual run-rate revenue as of the fourth quarter. This kind of growth at such scale is nothing short of impressive, but we continue to cast a cautious eye over its rising spending levels. Our fair value estimate for shares currently sits at ~$1,500 each, and Alphabet registered a 10 on the Valuentum Buying Index in early January.

Comparable Transaction Growth Returns for Chipotle!

Chipotle turned in impressively strong comparable restaurant sales growth in the fourth quarter of 2018, which included a surprise in comparable restaurant transaction growth, and digital sales continue to grow as a percentage of total sales as management emphasizes growth within the channel.

By Kris Rosemann

Shares of simulated Best Ideas Newsletter portfolio idea Chipotle (CMG) jumped in after-hours trading following the release of its fourth quarter earnings report February 6. Comparable restaurant sales growth came in at 6.1% on a year-over-year basis thanks to a 3.3% increase in menu prices and a 2%

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increase in comparable restaurant transactions. Digital sales jumped by nearly 66% from the year-ago period and accounted for 12.9% of total sales in the quarter, which is a notable increase from digital sales accounting for 11.2% of total sales in the third quarter of 2018. Total revenue growth in the period was a strong 10.4% on a year-over-year basis.

Menu price increases also helped boost Chipotle's margin performance in the fourth quarter as food, beverage and packaging costs as a percentage of revenue fell by 100 basis points from the year-ago period as higher menu prices and lower avocado prices more than offset higher freight costs and paper and packaging inflation. Restaurant level operating margin expanded to 17% in the period from 14.9% in the comparable period of 2017 thanks to leverage from comps growth offsetting wage inflation and higher promotional and marketing spending. Adjusted diluted earnings per share came in at $1.72 in the fourth quarter, up from $1.55 in the year-ago period.

Free cash flow generation impressed at Chipotle in the full-year 2018 as well, as the metric jumped nearly 33% from 2017 levels to $334 million. Cash flow provided by operations and capital spending in the full-year period both advanced at a ~33% rate as the company opened 137 new restaurants in the year and closed or relocated 54. This strong free cash flow generation helped improve Chipotle's already strong balance sheet, and it ended 2018 with roughly $250 million in cash and cash equivalents, which does not include ~$30 million in long-term restricted cash, and no debt on the books.

In 2019, management expects comparable restaurant sales growth to be in the mid-single digit range, and 140-155 new restaurant openings should help propel the top-line even higher. We cannot dispute CEO Brian Niccol's confidence following a quarter of solid growth acceleration, which he attributes to relevant marketing of quality products, which are backed by great operations, and the provision of more convenient access. The company's ability to drive growth via the digital channel is certainly noteworthy, and it continues to test new initiatives such as drive-thru lanes at some locations. However, it is worth noting that the company offered free delivery on any order worth $10 or more from December 18, 2018, through January 7, 2019, in its 'Chipotle Free Delivery Bowl.'

Promotionally-driven or not, Chipotle's fourth quarter performance was certainly impressive, and we're quite pleased with the performance of this idea since highlighting it in the simulated Best Ideas Newsletter portfolio in late April 2018 when shares were trading in the ~$422 range, which indicates a ~25% gain since then before considering the post-quarterly report rally. We're not making any changes to our fair value estimate at this time, but recent momentum in the business suggests that the upper bound of our fair value range ($610 per share) may be a reasonable estimate of its intrinsic value. We look forward to rolling the model forward once we the company's 10-K is released, and we're going to continue highlighting this idea in the simulated Best Ideas Newsletter portfolio.

General Motors Rallies, Tesla and Toyota Improve, Auto Parts Suppliers Getting Squeezed

We continue to like General Motors, and we think Tesla is getting back on the right track with its financials. Auto parts suppliers have faced their fair share of pressure in recent months as the potential for a slowdown in global light vehicle production rises and input cost inflation also makes its presence felt.

By Kris Rosemann and Brian Nelson, CFA

*General Motors Rallies…*continued on next page

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Image shown: General Motors may very well be on its way to $50+ per share.

On February 6, General Motors (GM) reported fourth-quarter 2018 earnings, and they were quite good. We continue to believe shares of GM are ultra-cheap, as we wrote in: "We Think General Motors Is Poised for New Highs." The automaker is included as an idea in both the Best Ideas Newsletter portfolio and Dividend Growth Newsletter portfolio. We value shares at $54 each, suggesting the potential for 35% upside based on its closing price February 6. We continue to believe GM's electric-vehicle line-up will be a hit, and with Cadillac leading the charge in that area, we think the risk is actually to the upside. Here's a quick synopsis of how GM ended the year:

> In 2018, GM reported strong full-year earnings per share-diluted-adjusted. Results were driven by strong pricing, surging crossover sales, successful execution of the company's full-size truck launch, growth of GM Financial earnings and disciplined cost control. Fullyear automotive adjusted free cash fow of $3.8 billion includes the impact of $600 million in pre-funding payments to certain non-U.S. pensions. Fourth quarter results were led by strong performance in GM North America, driven by a rich vehicle mix and strong pricing for GM's all-new full-size pickup trucks: the Chevrolet Silverado and GMC Sierra.

Tesla (TSLA) is what they call a battleground stock, and it seems like there is a tug-of-war every few weeks or so between the bulls and the bears. The company reported fourth-quarter results January 30, and we liked them, all things considered, of course. You won't see us adding Tesla to any newsletter portfolio, but free cash flow generation of $910 million in the fourth quarter, and most of that cash flow being added to the balance sheet to end the quarter with $3.7 billion at year-end is actually pretty good. We get the sense that a focus on free cash flow and balance-sheet health has become a priority, and we have to say that we like it. Nice job Tesla. Here are some highlights with respect to its outlook for 2019:

> Model 3 production volumes in Fremont should gradually continue to grow throughout 2019 and reach a sustained rate of 7,000 units per week by the end of the year. We are planning to continue to produce Model 3 vehicles at maximum production rates throughout 2019. Inclusive of Gigafactory Shanghai, where we are initially aiming for 3,000 Model 3 vehicles per week, our goal is to be able to produce 10,000 vehicles per week on a sustained basis. Barring unexpected challenges with Gigafactory Shanghai, we are targeting annualized Model 3 output in excess of 500,000 units sometime between Q4 of 2019 and Q2 of 2020.

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> We continue to target a 25% Model 3 non-GAAP gross margin at some point in 2019. While there are many moving parts that will ultimately determine gross margin, we believe that significant cost reductions combined with better fixed-cost absorption and careful management of mix should enable us to get to this profit level. We expect that gross margin for Model S and Model X should remain relatively stable compared to 2018.
>
> In total, we are expecting to deliver 360,000 to 400,000 vehicles in 2019, representing a growth of approximately 45% to 65% compared to 2018. **In this range, we are expecting to have positive GAAP net income and to generate positive free cash flow (operating cash flow less capex) in every quarter beyond Q1 2019.** We believe these results will be substantially driven by our restructuring action and the ongoing financial discipline with which we are managing the business.

General Motors, of course, is our favorite automaker when it comes to an investment consideration. Tesla is one of the best innovators, but we're also keeping an eye on Toyota (TM). We talk about the innovative Toyota Production System in our book *Value Trap*, and it's hard for us not to like Toyota, the company. At the moment, however, we only have room for one automaker in the simulated newsletter portfolios, and that slot goes to GM due to its outsize price-to-estimated fair value discount. Still, there's some exciting things happening at Toyota lately. Consolidated vehicle sales advanced nearly 2% through the first nine months of fiscal 2019, and net revenue and operating income also improved. Its outlook for the remainder of fiscal 2019 is solid, too.

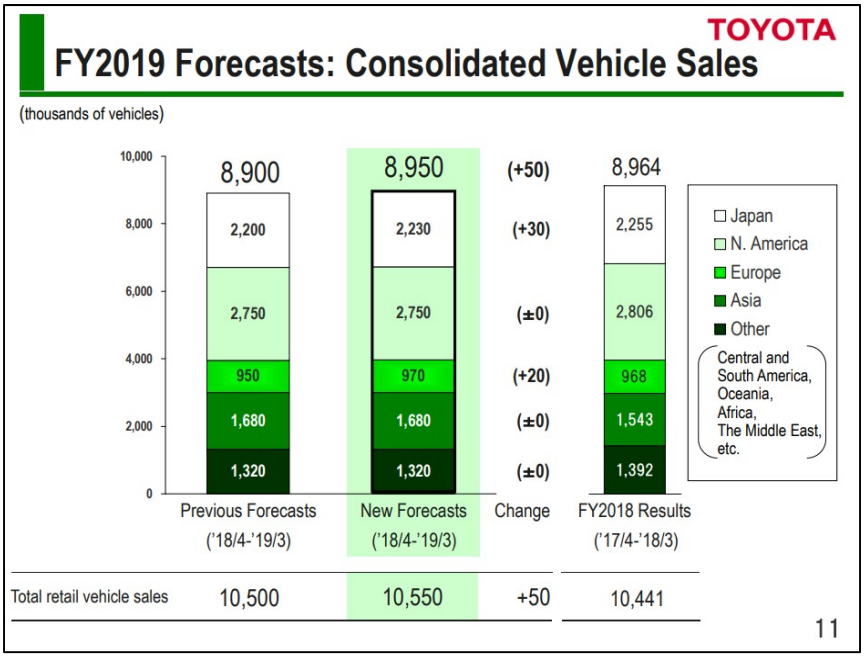

Image source: FY2019 Third Quarter Financial Results

Although the major global automakers are holding up fairly well, the auto parts suppliers space has found itself under a notable amount of pressure of late as a result of a number of factors beyond the control of the management teams within. Not only are trade tensions impacting demand in key markets and pressuring margin performance via rising input costs, but the potential for a material slowdown in global light vehicle production appears to be rising, and that may weigh more on the supply chain than the automakers themselves. The inherent cyclicality of the auto-parts supplier chain and the pressure of having to negotiate with only a few major customers is partly why we tend to steer clear of the autoparts arena.

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Said another way, the automakers have considerable bargaining power over suppliers in negotiating terms on some of the most largely-commoditized parts, all the while suppliers have considerable operating leverage and remain extremely competitive, which we think prevents outsize economic returns over the long haul. In general, we don't like the structure of the group. A number of auto parts suppliers found themselves struggling in the back half of 2018, and some were forced to cut guidance or lower expectations, both for the calendar year 2018 and beyond.

For example, Autoliv (ALV) extended the time horizon over which it expects to achieve its former 2020 financial targets. The targets remain unchanged at $10+ billion in sales and a ~13% adjusted operating margin, but management no longer expects to hit these goals in 2020. Autoliv still expects improvement towards its 2020 targets in the near term, but a slowdown in global light vehicle sales and production is anticipated in 2019. The first half of the year is likely to be challenging, with some improvement expected in the second half.

Delphi (DLPH) has been impacted by weakness in the Chinese (FXI, MCHI) auto market, and it expects to continue witnessing the impact of share loss by its local OEM customers in a weak market environment in the country. A slowdown in passenger car diesel engines, particularly in Europe (VGK), is also weighing on expectations. Local OEMs in China have faced significant reductions as their larger competitors are able to more effectively compete in a softer demand environment, and Goodyear Tire (GT) is another company that has seen its performance in China impacted by a weakening of its consumer base.

Superior Industries (SUP) may have faced as much selling pressure of any of its peers in recent months. The aluminum wheel manufacturer has been dealing with reduced shipments across Europe as a result of worldwide harmonized light vehicle test procedure emission standards and delayed spending from OEM customers in the United Kingdom (EWU). Rising energy costs have impacted its production base, particularly in Mexico (EWW), and higher launch costs have impacted margins in its European and North American operations. The company continues to battle tariff headwinds as a large consumer of aluminum. Though such costs are typically passed through to customers, higher prices have an impact on the demand curve.

Alternative parts supplier LKQ Corp (LKQ) also provided insight into the adverse cost environment the auto parts space is facing. The company noted that headwinds related to freight, vehicle, and fuel costs are impacting distribution costs, and wage and benefit inflation are also impacting its cost structure. These pressures are not expected to abate in the near term, making cost management all the more important for the company and its peers. We don't have any plans to add an auto parts supplier to our newsletter portfolios at this time, and we maintain our very positive view on the investment merits of General Motors.

Major Improvements in 2018 But Tough Times Ahead for Halliburton

Halliburton's 2018 performance was boosted by higher oil prices driving upstream capital spending, but tough times may very well lay ahead for the oilfield services provider.

By Callum Turcan

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While Halliburton's (HAL) financial performance improved materially last year as upstream capital expenditures perked up on the back of higher global oil prices, tough times lay ahead for this oilfield services provider given the current near-term outlook for oil prices. A large part of Halliburton's business caters to unconventional upstream operators in North America, which are quick to react to any changes in oil prices when it comes to setting capital expenditure budgets. 60% of Halliburton's revenue last year was generated in North America. Pricing pressures, particularly for well completion services, will likely continue to put significant downward pressure on its margins, and management is responding by curtailing Halliburton's capital expenditures.

2018 Recovery

Last year, many oilfield service providers breathed a sigh of relief as West Texas Intermediate and Brent rallied during the first half of the year due to OPEC+ production cuts and ongoing global demand growth. Non-OPEC output had to fill the gap, which meant significant increases in North American drilling and completion activity. As more rigs hit the shale patch and additional frac crews were mobilized to bring those wells online, things were looking up for Halliburton for a spell. Barclays' (BCS) published a survey in August 2018 that highlighted how North American upstream capital expenditures were expected to rise by 15% in 2018 on a year-over-year basis.

Increased upstream investments drove Halliburton's revenue up 16% year-over-year to $24.0 billion in 2018. Sales growth and an absence of major impairment charges led to margin expansion, with Halliburton's operating income rising 80% to $2.5 billion, and its operating margin climbed by 364 basis points from the year-ago period to 10.3%. Part of this significant operating income improvement is due to Halliburton's revenue growth, but it is also important to note that the firm recorded $0.6 billion in impairment and other charges in 2017, which fell by $0.4 billion in 2018. These are expenses that management has determined to be one-off items, but as always, one needs to view special items outside the purview of GAAP with a grain of salt.

Halliburton's 'Completion and Production' division generated $16.0 billion in sales last year, up 22% from 2017 levels. 'Completion and Production' revenue represents two-thirds of Halliburton's company-wide revenue, with its 'Drilling and Evaluation' division representing the remainder, and the division's revenue was up 6% on a year-over-year basis as sales grew to $8.0 billion last year.

Pain Ahead

The fourth quarter of 2018 brought a precipitous drop in oil prices, which led to a significant weakening in Halliburton's financial performance and highlights just how sensitive the company is to swings in raw energy resource markets. Management had this to say during the firm's fourth quarter of 2018 conference call:

> *"We finished the quarter with total company revenue of $5.9 billion and operating income of $608 million, representing a sequential decrease of 4% and 15% respectively. Our Completion and Production division revenue declined 8% sequentially and operating income was down 19%, driven by lower activity in pricing for stimulation services in North America. Our Drilling and Evaluation division delivered a strong quarter, growing revenue 5% and operating income 2% sequentially.*
>
> *While our business in North America declined this quarter as the completions market softened, internationally, we delivered 7% revenue growth, which underscores the versatility and global reach of our business portfolio. The trajectory of this cycle has been far from smooth. The end of last year saw a large swing in commodity prices with both Brent and WTI retrenching over 40%, the levels not seen since June of 2017."*

*Major Improvements…*continued on next page

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Management is expecting this pain to continue into the first quarter of 2019, and it forecasts sales from both its 'Completion and Production' and 'Drilling and Evaluation' divisions will fall by "mid-to-high single-digits" sequentially. That includes an expected 300 to 400 basis point drop in its 'Completion and Production' operating margin and a 100 to 150 basis point drop in its 'Drilling and Evaluation' operating margin.

Whether or not this picture improves as we get deeper into 2019 will largely be a function of global oil prices. Management is optimistic that new oil pipelines catering to the roaring Permian Basin will result in a major pickup in unconventional well completion activity during the second half of 2019 when those systems are operational, which would also alleviate some of the pricing pressures facing Halliburton. America is sitting on a recovery amount of drilled but uncompleted wells, almost 8,600 as of December 2018, offering Halliburton an enormous growth runway if oil prices rise to levels that encourage a drawdown in that inventory, which is another catalyst management referenced.

Dividend Analysis

Valuentum members know the emphasis we place on the visibility of free cash flow generation as it relates to a company's ability to make good on its existing dividend commitments and its potential to grow that yield over time. Halliburton's Dividend Cushion ratio stands at just 0.4, giving it a VERY POOR Dividend Safety rating, and shares yield ~2.3% as of this writing. A prolonged downturn in the upstream space could mean significant trouble for the company's payout.

In 2018, Halliburton generated $3.2 billion in operating cash flow which was enough to cover $2.0 billion in capital expenditures, $0.6 billion on its dividend payouts, and $0.4 billion in share repurchases. Halliburton spent $0.4 billion retiring debt last year, which is largely why the firm's cash balance moved lower by $0.3 billion over the course of 2018. When viewing 2018 results in a vacuum, it appears Halliburton could easily make good on its dividend payments over the years to come, but that doesn't take into account the volatile nature of the firm's financial performance on an ongoing basis.

Management is slashing Halliburton's 2019 capital expenditure budget by 20% versus 2018 levels to $1.6 billion, which will include investments in its new direction drilling platform (catering to the needs of the upstream unconventional space as well laterals get longer and longer) and an expansion of its Production business. We assign Halliburton an ATTRACTIVE Economic Castle rating as management has demonstrated the ability to consistently invest in projects that earn a return on invested capital that is reasonably above its weighted-average cost of capital.

A key area the company seeks to capitalize on is mature fields, which involves leveraging its investments in technology and utilizing those investments to enhance its existing prowess regarding enhanced oil recovery operations (EOR). Keep in mind that EOR operations, at least for now, have only been utilized on a widespread scale at conventional fields (specifically older oil fields). Unconventional EOR operations have only been tested at the pilot project level with mixed levels of success.

Taking Care of Old Fields

Primary recovery operations simply involve drilling production wells and pumping oil, natural gas, and natural gas liquids straight from the reservoir without the need for injection wells. In most circumstances, artificial lift is utilized during the primary recovery period to maintain consistent well productivity as artificial lift services enables hydrocarbons to reach the surface when reservoir pressure isn't enough by itself. Only 10% of any given field's oil originally in place is produced during the primary recovery phase.

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Secondary recovery operations involve drilling water and gas injection wells to maintain reservoir pressure and boost the total recovery rate at the field. If the oilfield produces associated gas, often that natural gas is reinjected back into the field unless there is already extensive natural gas handling infrastructure in the producing region. The secondary recovery phase can recover 20%-40% of the oil originally in place.

The goal for both the upstream and oilfield services industries is to increase the total recovery rate of these older fields north of 50%. Norway's storied oil industry is targeting as much as a 70% recovery rate, up from just below 50% as things stand today, which is extremely bold but probably a tad too optimistic. That being said, CO_2 injection operations in America are thought to potentially yield recovery rates close to 60%.

For Halliburton, the goal is to utilize 21st century solutions to fix 20th century problems and make a nice profit in the process. In light of most old oilfields producing less than half of the oil originally in place, there is a huge opportunity for any oilfield service provider than can increase recovery rates beyond what is achievable through secondary recovery operations. The oil industry is slowly undergoing a major digital transformation, but much more work needs to be done on this front. Halliburton received almost 900 patents last year and has made investments in digital technology a top priority.

Over the long term, the idea is that optimization improvements (less downtime due to digital infrastructure identifying faulty equipment before it breaks down, better producing and injection well placement due to enhanced geological modelling technology, greater understanding of how EOR operations influences reservoir pressure and how to prevent further losses in reservoir pressure over time) combined with engineering gains will increase recovery rates at oilfields all over the world. During Halliburton's fourth quarter conference call management commented:

> *"It is critical to understand how we prioritize technology investment. We spent money on developing or acquiring technologies that help our customers solve their asset challenges, drive better productivity and reliability, minimize downtime and improve asset velocity. This helps create meaningful differentiation and deliver returns on our technology investment."*

Conclusion

In the event the oilfield services market turns around during the second half of 2019 as Halliburton hopes, free cash flow (after covering its dividend payment) may be allocated to additional share buybacks. At the end of 2018, the firm's existing share repurchasing program had $5.3 billion in remaining buyback capacity, equal to 19% of Halliburton's market capitalization. Dividend increases are possible but may not be likely, and management's lack of reference to a potential increase during Halliburton's latest update and its volatile financial performance support this notion. We assign Halliburton a VERY POOR Dividend Growth rating, and its quarterly payout has been stagnant at $0.18 since mid-2014.

We aren't interested in Halliburton at this point in time due to the macro headwinds that will likely stymie its 2019 financial and operational performance. Halliburton isn't an upstream operator, but it is at the mercy of oil prices just like most of the industry. Our fair value estimate for the company currently sits at $35 per share.

Video Game Industry Adapting to Consumers and Technology

Adapting to consumer consumption trends is a necessity for video game makers, and rapidly improving technology standards are impacting the industry as producers work to deliver high-quality entertainment effectively. Long-term demand trends are generally bright, but continual innovation and adaptation will be necessary.

By Kris Rosemann

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Key Takeaways

Video game companies compete with all forms of entertainment for discretionary spending, and competition has never been greater.

Business models aimed at driving recurring revenue have disappointed with respect to their ability to reduce lumpy financial performance. Evolving delivery methods cannot reduce the hit-based nature of the industry.

We're not interested in adding exposure to the space, but operators within it do have some attractive qualities, not the least of which is the generally low capital-intensity of the businesses.

Video game companies are constantly competing will all forms of leisure-time activities, and keeping the attention of consumers with high-quality products is their only chance at continuing to earn a share of discretionary spending. The proliferation of mobile devices and improving mobile connectivity are enhancing the opportunities and challenges within the gaming industry, but demand for high-quality games remains as strong as ever. As EA (EA) CEO Andrew Wilson succinctly stated on the company's fiscal 2019 third quarter earnings call, "And above all else, great content continues to be the lifeblood of our industry."

The current evolution of the gaming space, however, has companies sorting out how to best deliver the high-quality content its customers demand. We recently saw Sony (SNE) report disappointing performance from its PlayStation business as it works to drive sales of its PlayStation 4 console despite strength in games software sales. Top-notch consoles are becoming increasingly less necessary to deliver a high-quality gaming experience, and this is a trend that is not going away. Investors need look no further than the rapid adoption of mobile computing devices and the impact it has had on the PC market for evidence of what may be coming, or is already happening, in gaming. A similar parallel can be drawn to rapid change in video consumption to streaming.

The coming implementation of 5G could accelerate this trend for game makers. Relative to competing entertainment sources, video games have a far lower tolerance for latency on wireless networks due to the heightened sensitivity of outcomes and user experiences to even split-second lags. In this sense, video game companies are reliant upon outside sources to develop reliable infrastructure that can be used to deliver products. Passive media such as video and music streaming are not as sensitive to these factors, which can make a meaningful difference when it comes to consumer time-based competition. Competition for consumers' time has never been greater.

The dynamics of the mobile gaming market are also changing as the industry ages, and it is made up of a small number of very successful games with a large number of far smaller games that struggle to remain economically viable franchises. EA estimates that the average age of top 20 game titles is currently more than three years, which is making it increasingly difficult for new games to gain a foothold. Despite changing delivery methods, the gaming space may very well remain hit-based for the foreseeable future.

The shift in gaming away from consoles, PCs, and physically delivered games is causing operators to redefine their business models. Subscription-based revenue and cloud gaming are expected to be significant growth opportunities as we move forward with improving technology, and subscription offerings are already growing. Tech giants like Alphabet (GOOG, GOOGL), Amazon (AMZN), Facebook (FB), and Microsoft (MSFT) will also play a role in the future of gaming as widespread hyperscale data centers will be necessary for streaming technology to improve on a large enough scale. The potential for vertical integration within the video game space may be a possibility moving forward as the combination of content creators (game publishers) and distribution provides (streaming providers) is not without precedent in other industries.

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Shares of video game publishers had benefit materially from expectations that business models emphasizing recurring revenue would reduce the potential lumpiness of quarterly results, but significant competition and an innate reliance on fickle consumer tastes have made realizing these benefits more difficult than expected.

Yet another avenue that aimed to remove some of the lumpiness from quarterly financial performance is the free-to-play model with in-game purchases. Social-gaming leader Zynga (ZNGA) has had success with this model with franchises such as FarmVille, and the massively popular 'Fortnite,' created by Epic Games, in which Tencent (TCEHY) owns a 40% stake, has had success with a free-to-play model that incorporates in-game purchases for upgrades. EA recently launched 'Apex Legends,' a direct competitor to Fortnite using the same kind of revenue model, and the company reported that it had 10 million user sign ups in just 72 hours. Demand for in-game purchases are still hit-driven to a large degree, as consumers must be willing to invest time and money in the games.

At the end of the day, consumers will be willing to pay for high-quality games, regardless of the revenue model incorporated. The key objective for game publishers remains the quality of their games, and the space is not commoditized in the slightest. Differentiation occurs in the quality of the product. Delivery methods are changing, and producers must adapt to consumer preferences in that regard. However, the highest-quality games will continue to rise to the top.

EA lowered its guidance for fiscal 2019 (ends March 2019) in its third quarter report, released February 5, as a result of a launch delay and significant levels of competition impacting the performance of big-name releases, and its reduction of expectations was felt across the space as investors extrapolated the difficulties in its business to peers Activision (ATVI) and Take-Two (TTWO). After initial selling pressure following the release, shares of EA have bounced back due to optimism over the future potential of 'Apex Legends,' but we're not expecting this kind of volatility to disappear any time soon.

Activision is expected to announce a material round of job cuts to address profitability issues, which suggests the challenges for the space are far from ironed out. Shares of Take-Two have experienced notable selling pressure since the February 6 release of its fiscal 2019 third quarter earnings despite strong demand for 'Red Dead Redemption 2' and increased guidance in a number of metrics. Expectations for a deceleration in recurrent consumer spending in its fiscal fourth quarter may be weighing on shares as outperformance in this area in its fiscal third quarter was driven by special editions of 'Red Dead Redemption 2,' and 'Grand Theft Auto Online' sales are expected to remain lower on a relative basis in fiscal 2019.

We are not interested in adding exposure to video game creators at this time due in large part to the number of challenges the space currently faces and the inherent volatility found in hit-driven demand environments, but there are a number of attractive qualities found in some industry constituents. The low capital-intensity of the group facilitates free cash flow generation, provided high-quality content is being produced, and the resulting cash-rich balance sheets help offset some of the inherent uncertainty the group faces.

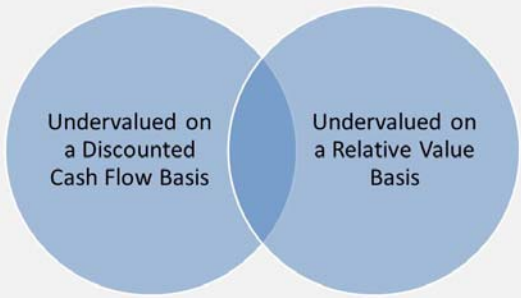
At the end of calendar 2018, EA held no debt on the books compared to nearly $5.2 billion in cash, cash equivalents, and short-term investments, and Take-Two also boasts a debt-free balance sheet with $1.6 billion in cash, cash equivalents, and short-term investments. Activision reported a net cash position of $638 million (comprised of $3.3 billion in cash and $2.7 billion in debt) at the end of the third quarter of calendar 2018 as it has been active in M&A in recent years.

EA and Take-Two are our two favorite ideas within this near-term challenged space, but shares of both companies are currently trading with our respective fair value ranges as of this writing. Investors should note the larger-than-average fair value ranges we use with these companies, as it reflects our thoughts surrounding heightened levels of uncertainty facing the group.

The Watch List

By Valuentum Analysts

The Valuentum Buying Index (VBI), which places a considerable emphasis on a firm's valuation, is the primary driver behind companies included in the simulated Best Ideas Newsletter 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/momentum 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. You'll see we often hold a number of these stocks in our portfolio, and we continue to monitor the remainder for the most opportune time to add them. The names on this list are the cream of the crop for the value investor and can supplement your "shopping list" of new ideas.

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

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

Company Name	Symbol	DCF Valuation	Relative Valuation	Price / Fair Value	Fair Value Estimate
General Motors	GM	UNDERVALUED	NEUTRAL	0.70	$54.00
Discover Financial	DFS	UNDERVALUED	UNATTRACTIVE	0.76	$102.00
Alliance Data Systems	ADS	UNDERVALUED	ATTRACTIVE	0.71	$229.00
j2 Global	JCOM	UNDERVALUED	ATTRACTIVE	0.70	$100.00
Verint	VRNT	UNDERVALUED	NEUTRAL	0.75	$56.00
Tupperware	TUP	UNDERVALUED	NEUTRAL	0.65	$47.00
LG Display	LPL	UNDERVALUED	UNATTRACTIVE	0.79	$11.00
Schlumberger	SLB	UNDERVALUED	NEUTRAL	0.70	$52.00
PayPal	PYPL	UNDERVALUED	NEUTRAL	0.79	$109.00
Cloud Peak	CLD	UNDERVALUED	UNATTRACTIVE	0.09	$4.00
Alibaba	BABA	UNDERVALUED	NEUTRAL	0.71	$206.00
Alphabet	GOOG	UNDERVALUED	NEUTRAL	0.74	$1512.00
Facebook	FB	UNDERVALUED	NEUTRAL	0.74	$226.00
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
Valero Energy	VLO	UNDERVALUED	NEUTRAL	0.76	$107.00
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...*from previous page

Sourcing Ideas from the Valuentum Buying Index

The first table below showcases stocks that may fit the bill of the Valuentum investor, with each posting a 9 or a 10 on the Valuentum Buying Index. These are names that we may swap into the simulated Best Ideas Newsletter portfolio on the long side (if not already held) should their upside potential become greater than our current holdings, in our view.

We also show firms that register a 1 or 2 on the VBI. These names represent put-option candidates, or stocks that we might generally avoid. We provide the respective lists below, and each company's stock report can be found on our website at www.valuentum.com.

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
Brown-Forman	BF.B	Beverages - alcoholic	1
Cintas Corp	CTAS	Commercial Services	1
Badger Meter	BMI	Electrical Equipment	1
Casella Waste	CWST	Environmental Services	1
Flowserve	FLS	Machinery & Tools	1
Graco	GGG	Machinery & Tools	1
IDEX	IEX	Machinery & Tools	1
Bright Horizons Family	BFAM	Personal Services	1
Amphenol Corp	APH	Electronic Suppliers	2
Corning	GLW	Electronic Suppliers	2
Dolby	DLB	Electronic Suppliers	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
Jack Henry	JKHY	IT Services	2
Norfolk Southern	NSC	Railroads	2
Allete	ALE	Utilities	2
MGE Energy	MGEE	Utilities	2
Sempra Energy	SRE	Utilities	2

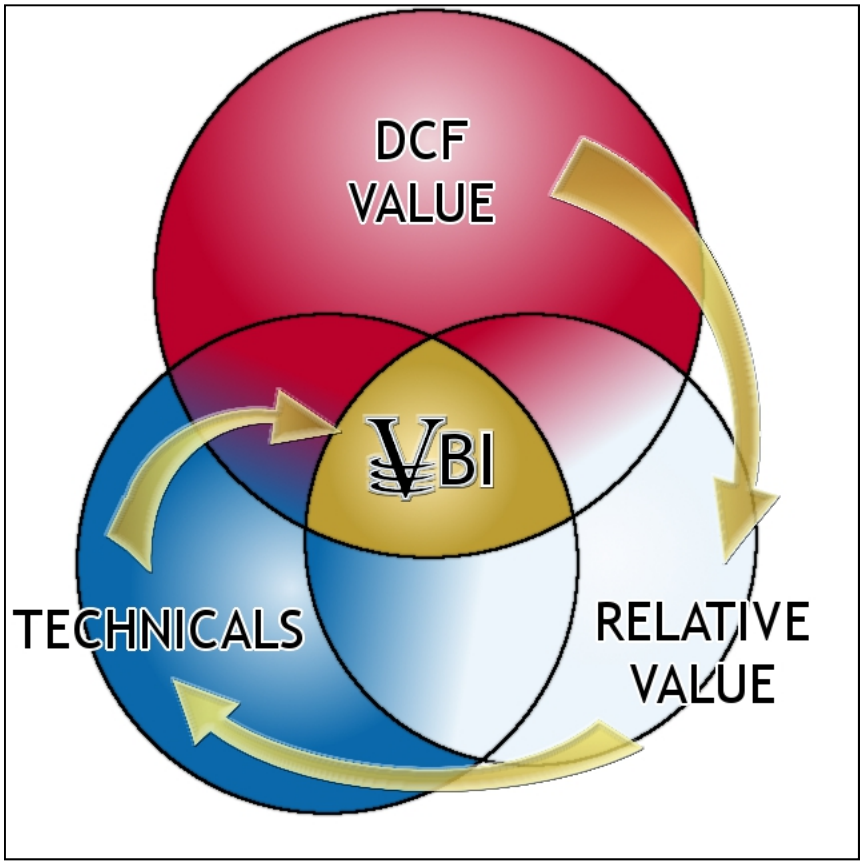
*Ideas...*continued on next page

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.

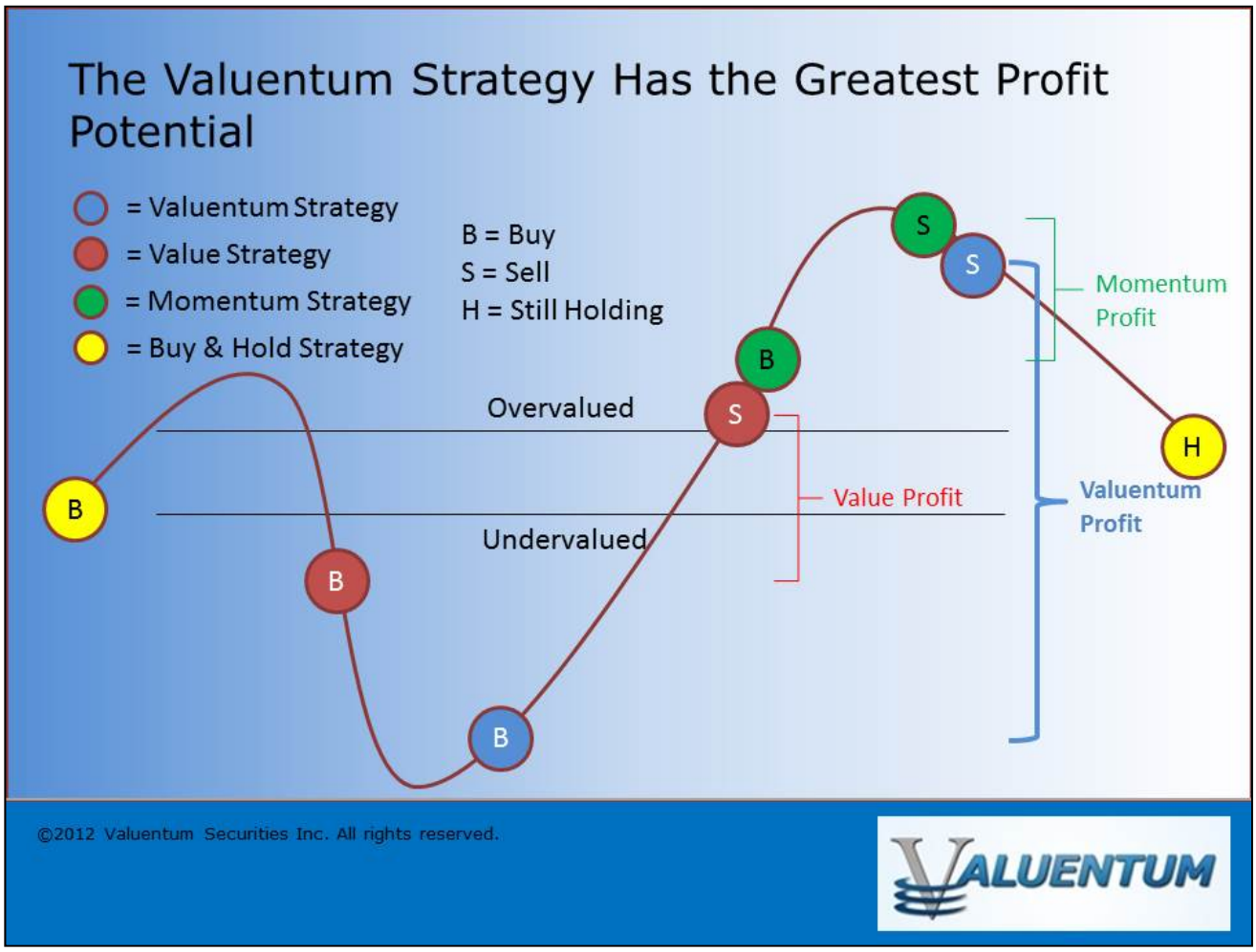


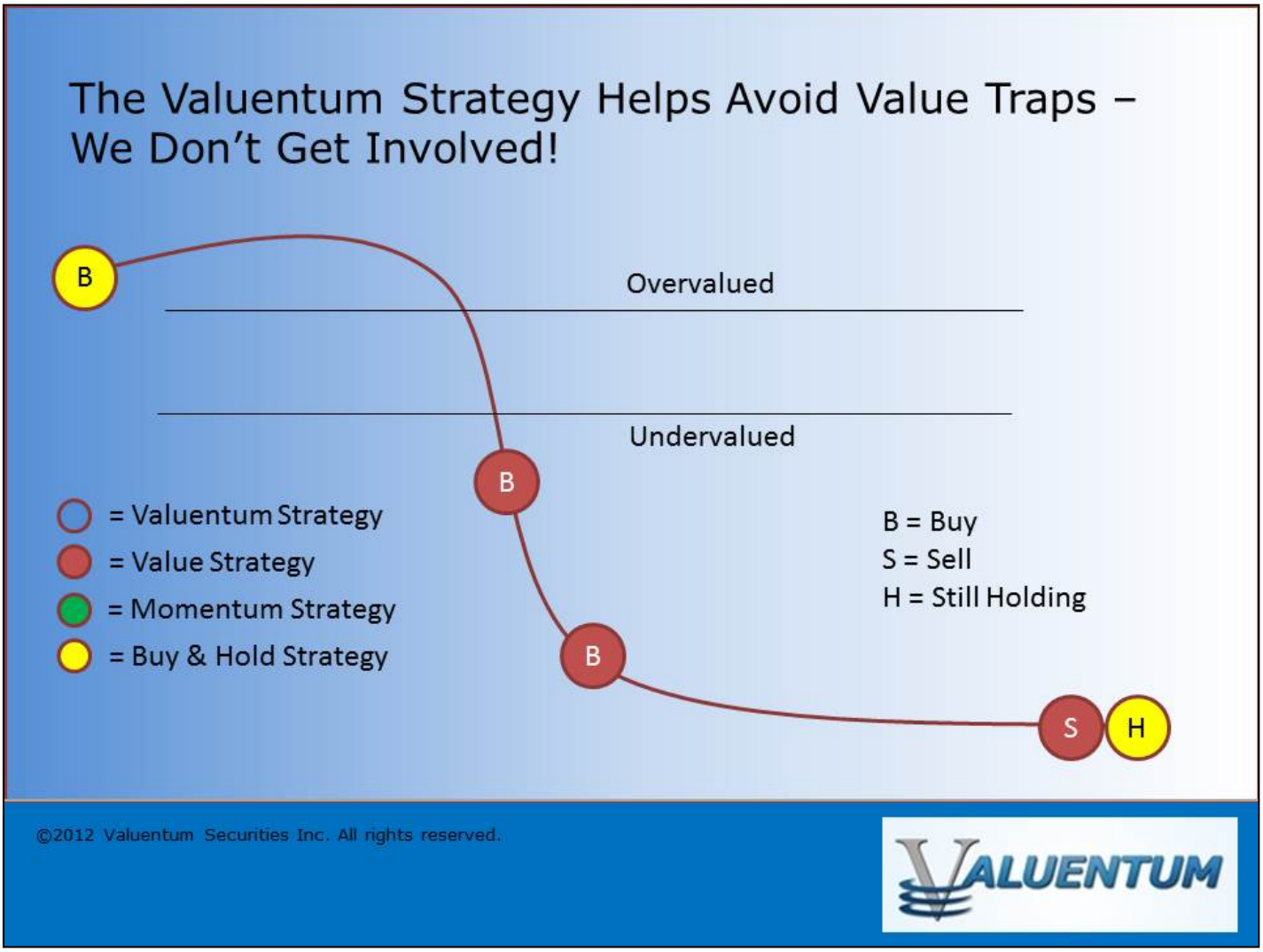
Illustration for educational purposes only.

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

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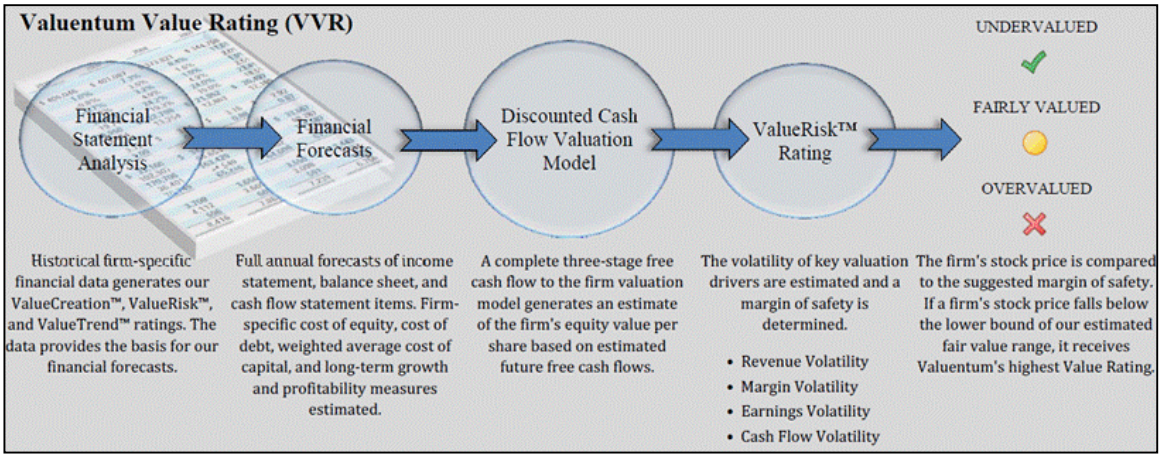
Let's walk through the three investment pillars of our stock-selection methodology.

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

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



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

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

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

Our Methodology – The Valuentum Buying Index continued on next page

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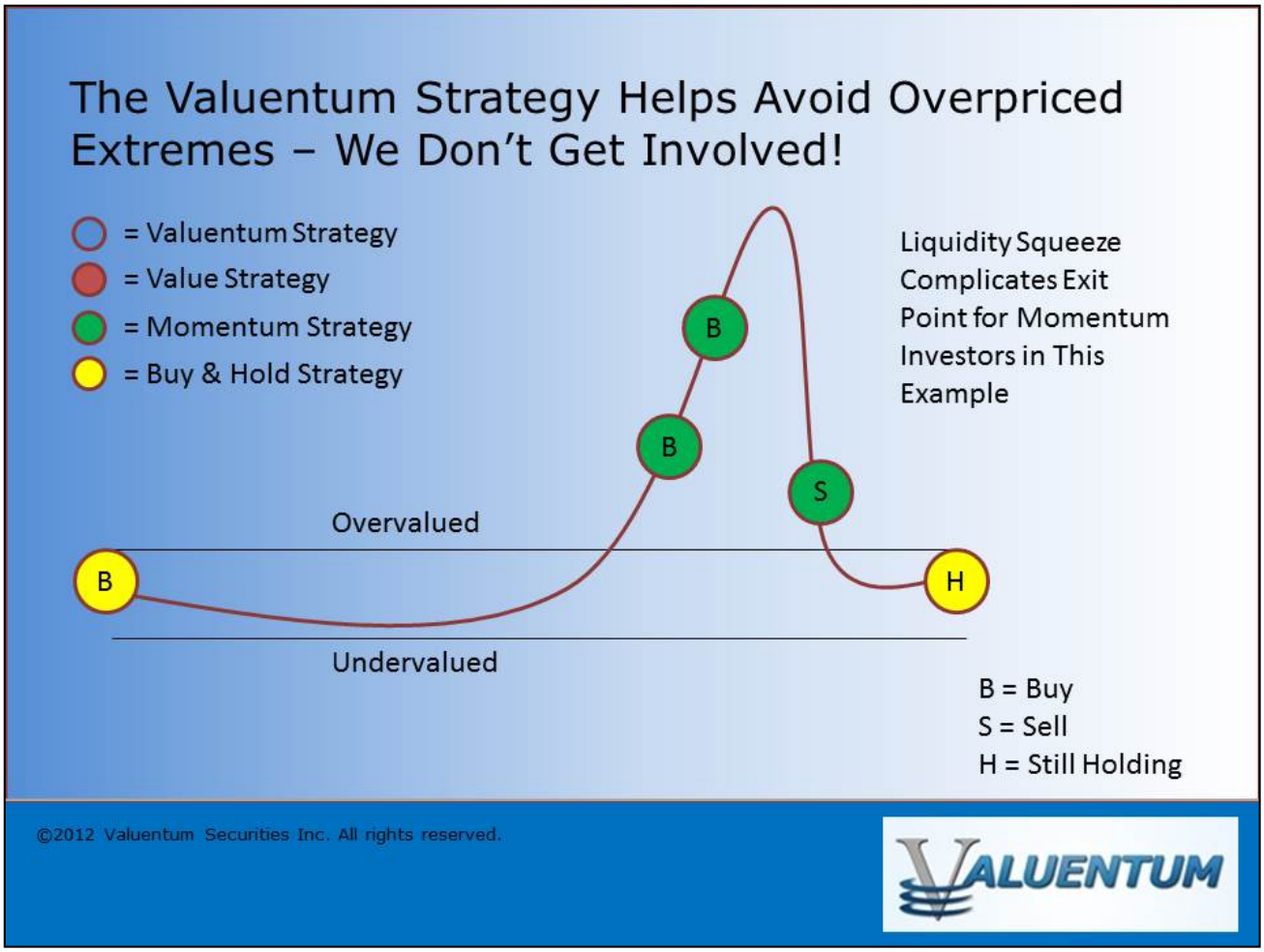

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II. The Valuentum Buying Index Incorporates A Forward-Looking Relative Value Assessment

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

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

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

Our Methodology – The Valuentum Buying Index continued on next page

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valuation criteria).

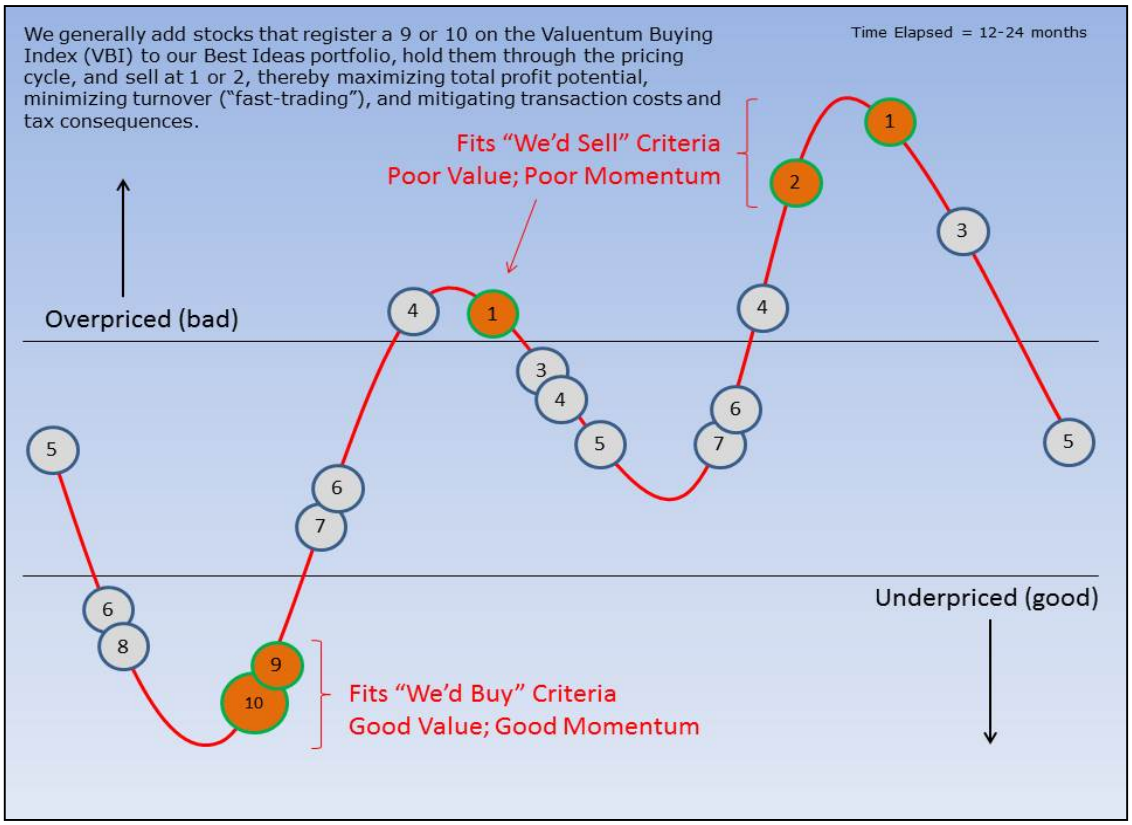
Rigorous valuation analysis and technical analysis are not mutually exclusive, and we believe both can be used together to bolster idea generation. An evaluation of a stock's moving averages, relative strength, upside-downside volume, and money flow index are but a few considerations we look at with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

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

Putting It All Together - the Valuentum Buying Index

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

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



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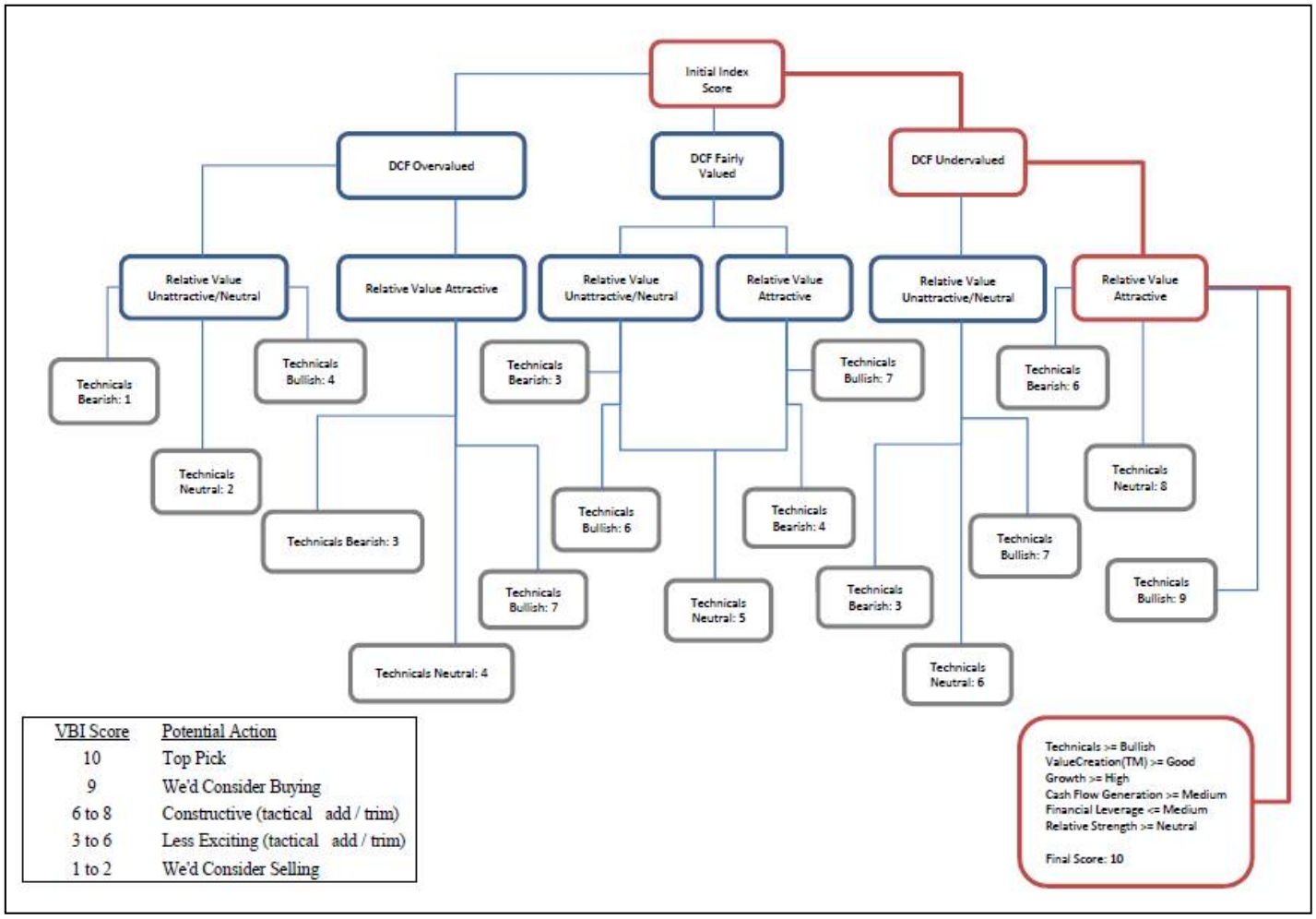
Our Methodology – The Valuentum Buying Index continued from previous page

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

First, the company would need to be 'UNDERVALUED' on a DCF basis and 'ATTRACTIVE' on a relative value basis. The stock would also have to be exhibiting 'BULLISH' technicals. The firm would need a ValueCreation rating of 'GOOD' or 'EXCELLENT', exhibit 'HIGH' or 'AGGRESSIVE' growth prospects, and generate at least a 'MEDIUM' or 'NEUTRAL' assessment for cash flow generation, financial leverage, and relative price strength.

This is a tall order for any company. Firms that don't make the cut for a 10 are ranked accordingly, with the least attractive stocks garnering a score of 1 ("We'd sell"). Most of our coverage universe falls between 3 and 7, but at any given time there could be large number of companies garnering either high or low scores, especially at market lows or tops, respectively.



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

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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?

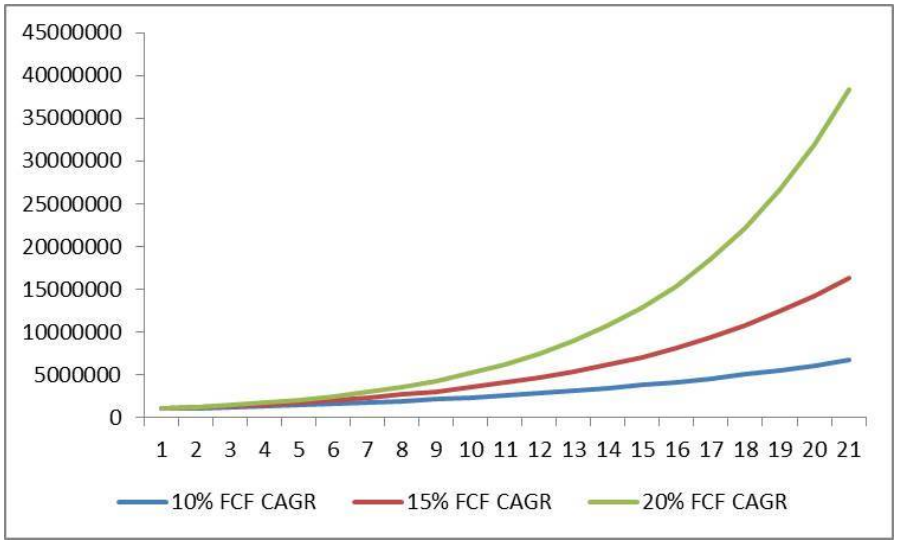
One of the most important concepts of the Valuentum methodology (and valuation in general) is the understanding that the value of a company is a range of probable valuation outcomes, not a single point estimate. Even well-seasoned stock analysts are guilty of saying that a company's shares are worth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



About the Fair Value Range continued on next page

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

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

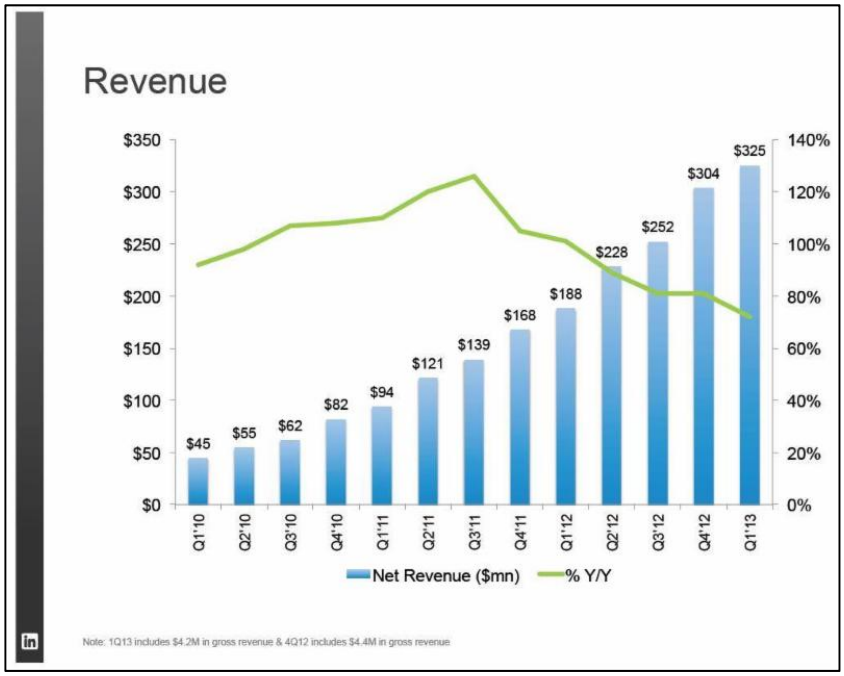


Image Source: LinkedIn

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

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

Shares collapsed in a huge way.

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

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

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

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

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

By Valuentum Analysts

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

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

The Valuentum Buying Index Has Checks and Balances

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

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

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

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

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

How We Use continued from previous page

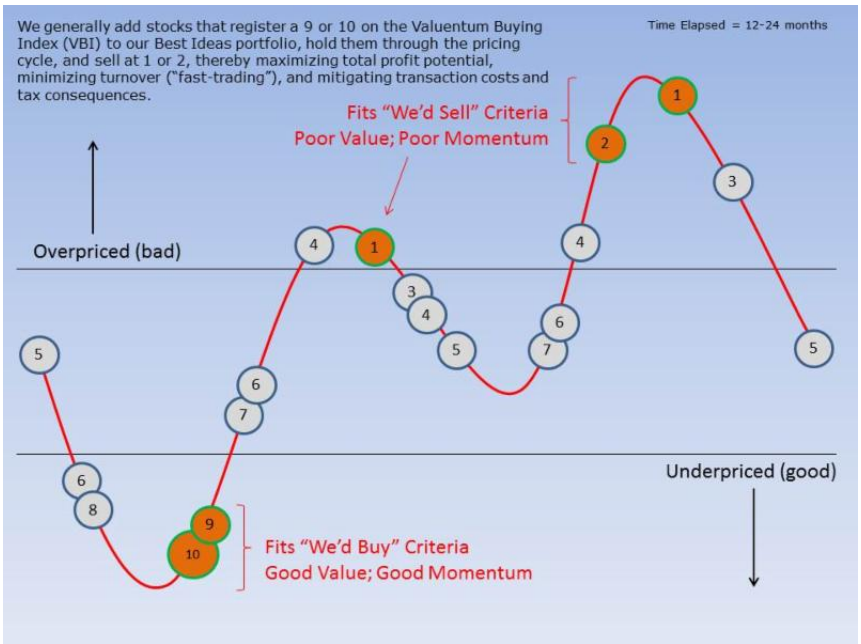
may be the secret to success in investing, a lot could have gone wrong with the temptation to do something each day. Obviously, we're very disciplined, but we also credit the portfolio outperformance to the VBI methodology itself. It is a very helpful tool.

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

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

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

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



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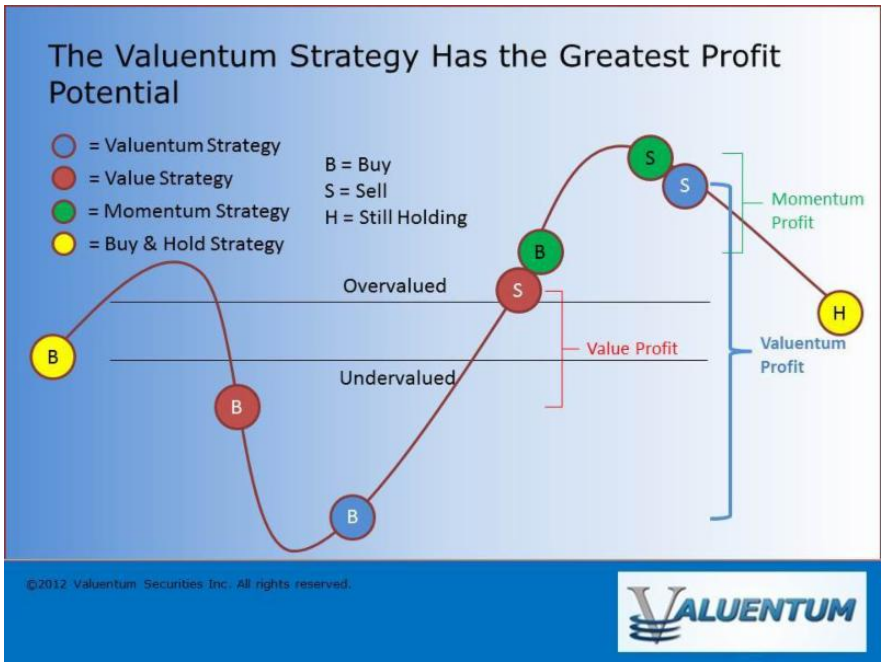
*How We Use...*continued on next page

How We Use continued from previous page

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.

** 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. Valuentum is an investment research publishing company.*

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.

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