OUR BEST IDEAS NEWSLETTER

Valuentum Securities

Stock Analysis: From Value through Momentum Investing

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

Recently Removed: XLE, XLF (August 14, 2019)

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"The growing possibility for a narrow US-China trade deal getting approved has had a positive impact on global equity markets. It would take a long lasting and concrete deal to shore up lackluster business confidence, however, and temporary truces won't change much on that front.

- Callum Turcan

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Apple Surges Higher!

Image Shown: *Shares of Apple continue to surge higher and were supported by positive US-China trade talk news on Friday October 11.*

A version of this article was emailed to subscribers on October 11.

By Callum Turcan

One of our favorite companies, Apple (AAPL), has been off to the races with shares pushing up into the mid-$230s as of this writing. Apple is a top holding in both our Best Ideas Newsletter and Dividend Growth Newsletter portfolios. We value Apple at up to $266 per share at the top end of our fair value estimate range, and shares of AAPL yield 1.3% as of this writing. Please note Apple's fiscal year ends in late September. Let's start out by covering an area Apple has had some trouble with over the past few fiscal years, and where the company can generate upside going forward.

A Problem and an Opportunity

Apple's GAAP gross margins came under pressure from FY2016 to FY2018, with management citing higher product cost structures and the negative impact of a strong US dollar relative to other currencies. Ongoing strength in the US dollar continued to play a role in pressuring Apple's margins in fiscal 2019, as did lower iPhone unit sales. Additionally, Apple is exposed to the escalating US-China trade war to some degree, but there has been positive movement on that front very recently (particularly during trade talks held October 10-11).

*Apple Surges...*continued on next page

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Goal of the Best Ideas Newsletter

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

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Apple				
Fiscal Period	FY2016	FY2017	FY2018	First 3 Quarters of FY2019
GAAP Gross Margin	39.1%	38.5%	38.3%	37.8%

***Image Shown**: Apple's GAAP gross margins have come under pressure over the past few fiscal years in part due to the negative impact of a stronger US dollar. **Image Source:** Apple – FY2018 Annual Report, third quarter FY2019 10-Q filing, table created by the author*

During the first three quarters of fiscal 2019, Apple's 'Product' segment reported a gross margin of 32.4%, down 220 basis points from the same period in the prior year (management cited lower unit iPhone sales as one of the culprits). However, the company's 'Services' segment reported a 300 basis point increase in its gross margin during this period, hitting 63.6%. Scale is key here as Apple's 'Services' business continues to grow. The segment's net sales were up 13% year-over-year in the third quarter and 16% during the first three quarters of fiscal 2019, while Apple's total revenue was down 2% and 3%, respectively, during these periods. **Here we must stress that we view Apple's growing 'Services' revenue as underpinning our forecast that calls for the company's EBIT margin to expand modestly over the coming fiscal years (particularly compared to FY2017-FY2018 levels).**

During the first three quarters of FY2019, 'Services' represented ~17% of Apple's net sales. That was up from ~14% during the same period the prior fiscal year, and we expect this upward trend to continue going forward with Apple getting ready to launch its own streaming service Apple TV+ at the beginning of November. Apple just recently launched its own gaming subscription service Apple Arcade back in September, highlighting the many avenues Apple can pursue when seeking 'Services' sales growth. Here's what Apple's CFO, Luca Maestri, had to say during the firm's third quarter FY2019 quarterly conference call with investors (emphasis added):

> *"**Turning to 'Services', we reached an all-time revenue record in spite of foreign exchange headwinds with double-digit growth from the App Store, Apple Music, cloud services, and AppleCare, and triple digit growth from Apple Pay and our App Store search ad business**. All geographic segments had double-digit growth in services revenue and set new June quarter records with all-time records in the Americas and Rest of Asia Pacific. **In total, services accounted for 21% of Apple revenue and 36% of gross margin dollars.***
>
> *Customer engagement in our ecosystem continues to grow. The number of transacting accounts on our digital content stores reached a new all-time high in the June quarter and the number of paid accounts grew strong double digits compared to last year. **We now have over 420 million paid subscriptions across the services on our platforms and we are well on our way to our goal of surpassing the 500 million mark during 2020.**"*

How well Apple TV+ performs in terms of subscription growth will be driven in part by the low starting price the company has opted for. Apple plans to charge just $4.99 per month for Apple TV+, below the starting price offered by Netflix (NFLX), by Hulu (majority owned by Disney (DIS) with Comcast (CMCSA) owning the rest), and lower than the monthly non-promotional price offered by the upcoming Disney+ streaming service that's also going live this November. That should give Apple an edge in the roaring streaming wars, an edge made possible by its impressive financial position (enormous free cash flows and large net cash load). Analysts are likely to pay very close attention to the subscription numbers of Apple TV+ given the sheer size of the total addressable market ("TAM") this offering is catering towards, and the hefty costs associated with creating a sizable amount of original content.

Apple Surges...continued on next page

*Apple Surges…*from previous page

Apple Arcade starts at $4.99 per month and is competing with Alphabet's (GOOG) (GOOGL) Google Play Pass which costs about the same amount per month. Subscription based sales may cannibalize some of Apple's App Store sales, but in the long run this offering could build up the kind of sticky recurring revenue streams that investors often appreciate. **These are the kind of revenue streams that are well suited to supporting quality free cash flow profiles (consistent revenue, high margins, plenty of visibility as it relates to future financial performance, relatively low capital expenditure requirements to support these types of operations on an ongoing basis after an initial build out of infrastructure, i.e. data centers).**

Concluding Thoughts

We continue to like Apple and think shares will continue advancing toward the upper end of our fair value estimate range ($260+). Recent technical strength at Apple is possibly a sign that investors are beginning to price in the very positive tailwind the tech giant's 'Services' segment represents in terms of both sales and margin upside (and the positive effect that has on Apple's expected future free cash flows).

***Disclosure**: Callum Turcan owns shares of Apple Inc (AAPL).*

Covering Holding Berkshire Hathaway

***Image Source**: Berkshire Hathaway Inc – 2018 Annual Report*

By Callum Turcan

As a top holding in our Best Ideas Newsletter portfolio, Berkshire Hathaway Inc (BRK.A) (BRK.B) Class B shares have room to run in our view. Our fair value estimate for BRK.B stands at $229 per share, significantly higher than where shares are trading at as of this writing (~$204 per share). Please note Berkshire Hathaway does not pay out a common dividend at this time.

Covering a Tricky Balance Sheet

The conglomerate splits its operations into two; 'Insurance and Other' and 'Railroad, Utilities, and Energy,' with Berkshire Hathaway breaking down the financial performance of each segment when possible.

Berkshire Hathaway's 'Insurance and Other' segment had a large net cash-like position of $356.8 billion at the end of June 2019 (when defined as cash, cash equivalents, short-term investments in US Treasuries, investments in fixed maturities, investments in equity securities, and equity method investments that included Berkshire Hathaway's ~26.7% stake in Kraft Heinz Co's (KHC) outstanding share count at the end of this period). That cash-like position was modestly offset by $36.0 billion in notes payable and other borrowings at the end of the second quarter. However, **this doesn't tell the whole story. Berkshire Hathaway has numerous insurance business-related liabilities that require maintaining a large cash balance in order to pay out claims to policy holders, making the firm's balance sheet a tricky read.** Pivoting to its other operations, Berkshire Hathaway's 'Railroad, Utilities, and Energy' segment had a net debt position of $60.6 billion ($3.3 billion in cash less $63.9 billion in total debt) at the end of the second quarter. At the top of the next page (Page 4) is a look at Berkshire Hathaway's financial status as of the end of June 2019.

*Covering Berkshire…*continued on next page

*Covering Berkshire...*from previous page

Part I Financial Information
Item 1. Financial Statements
BERKSHIRE HATHAWAY INC.
and Subsidiaries
CONSOLIDATED BALANCE SHEETS
(dollars in millions)

	June 30, 2019 (Unaudited)	December 31, 2018
ASSETS		
Insurance and Other:		
Cash and cash equivalents*	$ 41,375	$ 27,749
Short-term investments in U.S. Treasury Bills	77,745	81,506
Investments in fixed maturity securities	19,962	19,898
Investments in equity securities	200,516	172,757
Equity method investments	17,208	17,325
Loans and finance receivables	16,807	16,280
Other receivables	33,941	31,564
Inventories	19,834	19,069
Property, plant and equipment	21,204	20,628
Equipment held for lease	14,741	14,298
Goodwill	56,487	56,323
Other intangible assets	31,032	31,499
Deferred charges under retroactive reinsurance contracts	13,634	14,104
Other	13,097	9,307
	577,583	532,307
Railroad, Utilities and Energy:		
Cash and cash equivalents*	3,259	2,612
Receivables	3,641	3,666
Property, plant and equipment	133,515	131,780
Goodwill	24,782	24,702
Regulatory assets	3,073	3,067
Other	14,255	9,660
	182,525	175,487
	$ 760,108	$ 707,794

* *Cash and cash equivalents included U.S. Treasury Bills with maturities of three months or less when purchased of $16.2 billion at June 30, 2019 and $3.9 billion at December 31, 2018.*

Image Shown: *Berkshire Hathaway had a lot of cash and cash equivalents on the books to cover future insurance payouts and potentially make large investments, as of the end of the second quarter of 2019.* ***Image Source:*** *Berkshire Hathaway – Second quarter 2019 10-Q filing*

BERKSHIRE HATHAWAY INC.
and Subsidiaries
CONSOLIDATED BALANCE SHEETS
(dollars in millions)

	June 30, 2019 (Unaudited)	December 31, 2018
LIABILITIES AND SHAREHOLDERS' EQUITY		
Insurance and Other:		
Unpaid losses and loss adjustment expenses	$ 70,781	$ 68,458
Unpaid losses and loss adjustment expenses under retroactive reinsurance contracts	41,549	41,834
Unearned premiums	20,113	18,093
Life, annuity and health insurance benefits	19,155	18,632
Other policyholder liabilities	7,826	7,675
Accounts payable, accruals and other liabilities	25,468	25,776
Derivative contract liabilities	1,470	2,452
Aircraft repurchase liabilities and unearned lease revenues	5,146	4,593
Notes payable and other borrowings	36,025	34,975
	227,533	222,488
Railroad, Utilities and Energy:		
Accounts payable, accruals and other liabilities	15,120	11,410
Regulatory liabilities	7,560	7,506
Notes payable and other borrowings	63,882	62,515
	86,562	81,431
Income taxes, principally deferred	59,622	51,375
Total liabilities	373,717	355,294
Shareholders' equity:		
Common stock	8	8
Capital in excess of par value	35,610	35,707
Accumulated other comprehensive income	(4,678)	(5,015)
Retained earnings	356,846	321,112
Treasury stock, at cost	(5,242)	(3,109)
Berkshire Hathaway shareholders' equity	382,544	348,703
Noncontrolling interests	3,847	3,797
Total shareholders' equity	386,391	352,500
	$ 760,108	$ 707,794

Image Shown: *Berkshire Hathaway's balance sheet can be a tricky read given its large insurance operations.* ***Image Source:*** *Berkshire Hathaway – Second quarter 2019 10-Q filing*

*Covering Berkshire...*continued on next page

*Covering Berkshire…*from previous page

Berkshire Hathaway invested $10.0 billion into a preferred equity issuance by Occidental Petroleum Corporation (OXY) that was contingent on Occidental Petroleum's purchase of Anadarko Petroleum going through, which it did. Now Berkshire Hathaway should be the proud owner of preferred shares in Occidental Petroleum that come with a hefty 8% coupon, quite the return given the size of the investment, and that's on top of Berkshire Hathaway gaining warrants to acquire 80 million OXY shares at $62.50 per share. **This investment was expected to close soon after the acquisition was completed, which occurred during the third quarter of 2019.** We will be scanning through Berkshire Hathaway's third quarter 2019 10-Q filing to find more information on this transaction when it becomes available.

While Occidental Petroleum trades at just ~$41 per share as of this writing, the warrants Berkshire Hathaway is obtaining give the conglomerate exposure to a recovery in raw energy resource prices. The 8% coupon on the preferred issuance is arguably quite generous, but please keep seniority in mind if Occidental Petroleum faces financial distress. Occidental Petroleum is currently embarking on a wide-ranging divestment program to pay down debt taken on after acquiring Anadarko Petroleum, a strategy that should work in Berkshire Hathaway's favor.

On the tenth year anniversary of the preferred issuance, Berkshire Hathaway can have the preferred equity redeemed at 105% of the liquidation preference (face value) plus any accrued but unpaid dividends. On the downside, Occidental Petroleum does have the option to pay Berkshire Hathaway in common stock (we think cash will be the preferred choice of payment given the high 7.7% yield shares of OXY currently carry).

Cash Flow Commentary

Berkshire Hathaway generated $38.6 billion in annual net operating cash flows on average from 2016-2018 while spending $13.1 billion on capital expenditures per year on average during this period. The cash generated from these strong free cash flows were largely added to Berkshire Hathaway's balance sheet, with the conglomerate spending just $1.3 billon in 2018 (and nothing in 2016-2017) on share repurchases. That's because Berkshire Hathaway's current share buyback program was amended in 2018. Here's more information on that from Berkshire Hathaway's second quarter 2019 10-Q filing (emphasis added):

> *"For several years, Berkshire had a common stock repurchase program, which permitted Berkshire to repurchase its Class A and Class B shares at prices no higher than a 20% premium over the book value of the shares.* ***On July 17, 2018, Berkshire's Board of Directors authorized an amendment to the program, permitting Berkshire to repurchase shares any time that Warren Buffett, Berkshire's Chairman of the Board and Chief Executive Officer, and Charles Munger, Vice Chairman of the Board, believe that the repurchase price is below Berkshire's intrinsic value, conservatively determined.*** *Repurchases may be in the open market or through privately negotiated transactions."*

As the company does not currently pay out a common dividend and is unlikely to do so for the foreseeable future, Berkshire Hathaway will likely continue to grow its cash-like hoard going forward. **Please note Berkshire Hathaway did repurchase $2.1 billion of its stock during the first half of 2019, but that paled in comparison to the $10.0 billion in free cash flows the conglomerate generated over this period.** Only major acquisitions have historically put a meaningful dent in Berkshire Hathaway's cash pile, and CEO Warren Buffett has largely been on the sidelines over the past few years due to what he sees as lofty valuations for many investment opportunities (across the board). In the graphic at the top of the next page (Page 6), please note Berkshire Hathaway's strong free cash flows.

*Covering Berkshire…*continued on next page

*Covering Berkshire...*from previous page

BERKSHIRE HATHAWAY INC.
and Subsidiaries
CONSOLIDATED STATEMENTS OF CASH FLOWS
(dollars in millions)

	Year Ended December 31,		
	2018	2017	2016
Cash flows from operating activities:			
Net earnings	$ 4,322	$ 45,353	$ 24,427
Adjustments to reconcile net earnings to operating cash flows:			
Investment gains/losses	22,155	(1,410)	(7,553)
Depreciation and amortization	9,779	9,188	8,901
Other	2,957	458	(161)
Changes in operating assets and liabilities:			
Losses and loss adjustment expenses	3,449	25,027	4,372
Deferred charges reinsurance assumed	1,174	(7,231)	(360)
Unearned premiums	1,794	1,761	968
Receivables and originated loans	(3,443)	(1,990)	(3,302)
Other assets	(1,832)	(1,665)	(373)
Other liabilities	2,002	1,194	1,684
Income taxes	(4,957)	(24,957)	4,044
Net cash flows from operating activities	37,400	45,728	32,647
Cash flows from investing activities:			
Purchases of U.S. Treasury Bills and fixed maturity securities	(141,844)	(158,492)	(96,568)
Purchases of equity securities	(43,210)	(20,326)	(16,508)
Sales of U.S. Treasury Bills and fixed maturity securities	39,693	49,327	18,757
Redemptions and maturities of U.S. Treasury Bills and fixed maturity securities	113,045	86,727	26,177
Sales and redemptions of equity securities	18,783	19,512	28,464
Purchases of loans and finance receivables	(1,771)	(1,435)	(307)
Collections of loans and finance receivables	342	1,702	490
Acquisitions of businesses, net of cash acquired	(3,279)	(2,708)	(31,399)
Purchases of property, plant and equipment and equipment held for lease	(14,537)	(11,708)	(12,954)
Other	(71)	(3,608)	(377)
Net cash flows from investing activities	(32,849)	(41,009)	(84,225)
Cash flows from financing activities:			
Proceeds from borrowings of insurance and other businesses	2,409	2,645	14,172
Proceeds from borrowings of railroad, utilities and energy businesses	7,019	3,013	3,077
Repayments of borrowings of insurance and other businesses	(7,395)	(5,465)	(2,577)
Repayments of borrowings of railroad, utilities and energy businesses	(4,213)	(3,549)	(2,123)
Changes in short term borrowings, net	(1,943)	2,079	130
Acquisition of treasury stock	(1,346)	—	—
Other	(343)	(121)	112
Net cash flows from financing activities	(5,812)	(1,398)	12,791
Effects of foreign currency exchange rate changes	(140)	248	(172)
Increase (decrease) in cash and cash equivalents and restricted cash	(1,401)	3,569	(38,959)
Cash and cash equivalents and restricted cash at beginning of year	32,212	28,643	67,602
Cash and cash equivalents and restricted cash at end of year *	$ 30,811	$ 32,212	$ 28,643
** Cash and cash equivalents and restricted cash at end of year are comprised of the following:*			
Insurance and Other	*$ 27,749*	*$ 28,673*	*$ 24,109*
Railroad, Utilities and Energy	*2,612*	*2,910*	*3,939*
Restricted cash, included in other assets	*450*	*629*	*595*
	$ 30,811	*$ 32,212*	*$ 28,643*

***Image Shown**: Berkshire Hathaway is very free cash flow positive and we like the stability of its net operating cash flows. As the conglomerate has not historically repurchased a significant amount of its stock or paid out a common dividend, the firm has historically been able to quickly build up a large net cash-like position. **Image Source**: Berkshire Hathaway – 2018 Annual Report*

Concluding Thoughts

There's a lot to like about Berkshire Hathaway's stable cash flow profile and future growth trajectory. We continue to like Berkshire Hathaway's ability to navigate turbulent markets and think the firm is in a prime position to take advantage of any downturn in valuations at-large through very advantageous deals (whether that be outright acquisitions, preferred equity transactions, or investments in publicly traded equities).

***Disclosure**: Callum Turcan does not own any of the companies mentioned above.*

5 Questions Answered by the Valuentum Team

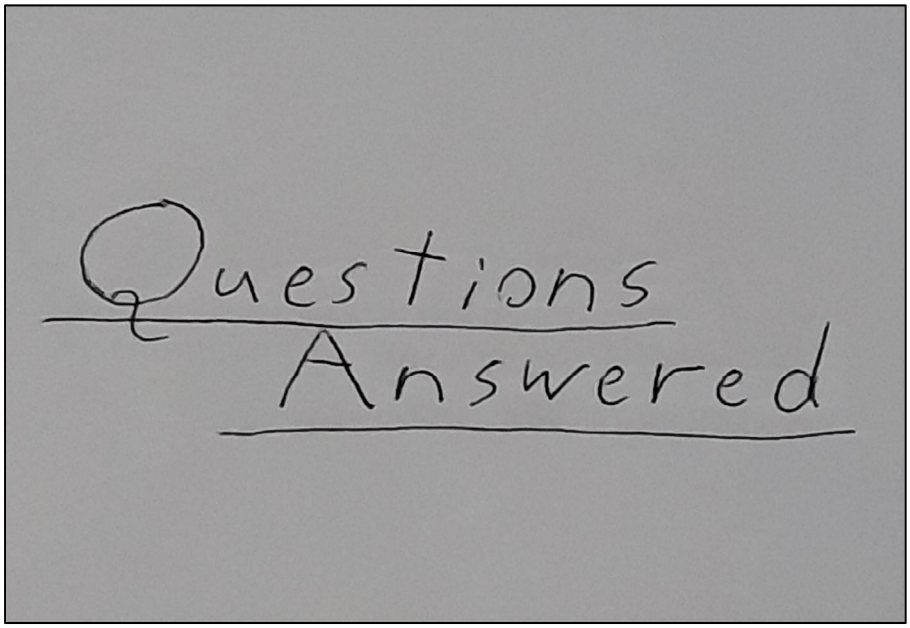

Image Source: *Picture created by Valuentum team member Callum Turcan*

By Valuentum Analysts

1. On the 16-page Reports

QUESTION: When I look at the company vitals information on the left side of the first part of each stock page, are the 'Est. Normal Diluted EPS' and 'P/E on Est. Normal Diluted EPS' essentially the same as 12-month forward EPS and 12-month forward P/E I see from other data sources (just worded differently and based on your estimates rather than "consensus figures")? It seems like this would be the case, but I wanted to double check. Do you all back out the company's net cash position when looking at this metric?

ANSWER: Our normalized P/E ratios and EV/EBITDA ratios consider the companies' current price relative to the average earnings or average EBITDA over a reasonable forward-looking cycle, generally five years. For example, the 'Est. Normal Diluted EPS' will take the price at the time of the report and divide that by the average annual EPS over the next five years. The same process occurs with respect to the current price of EV (market cap plus book value of debt, preferred) divided by the average of annual EBITDA over the next five years.

The normalized measures are unique as they take into consideration our forecasts over the next five years within the context of our enterprise discounted cash flow process. The net cash position is not backed out of the 'Est. Normal Diluted EPS.' The net cash position is considered in our fair value estimate, namely the price-to-fair value (P/FV) ratio as well as in the context of enterprise value (EV), applied within the EV/EBITDA multiple, for example. – *Brian Nelson, CFA*

2. Zimmer Biomet

QUESTION: *I wanted to ask you about your recent cautious update on Zimmer. I agree that operating income and cash flows came in weak this quarter. But the management commentary on the call was really positive (although there were no questions on cash flows). Zimmer, as you well know, has been struggling with their turnaround. But if the turnaround is about over, then their fundamentals should start to improve. I was thinking that we would finally start to see margin improvement over the next few years. This obviously isn't your take. Do you believe management isn't being sincere?*

*5 Questions...*continued on page 9

Valuentum's Best Ideas Portfolio

By Valuentum Analysts

Latest newsletter portfolio changes
August 14: **Removed XLE, XLF**

Valuentum's BEST IDEAS -- as of October 15, 2019 -- interim

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	0.92	209.68	7%-12%
Facebook	FB	0.00%	$234.00	Very Attractive	3	0.81	189.77	7%-12%
Alphabet - Class C	GOOG	0.00%	$1440.00	Very Attractive	4	0.86	1232.80	7%-12%
Visa	V	0.56%	$182.00	Attractive	6	0.98	179.07	7%-12%
Apple Corp.	AAPL	1.38%	$222.00	Highest Rated	6	1.06	236.28	7%-12%
SPDR S&P Dividend ETF	SDY	2.43%	NA	NA	UR	NMF	102.36	5.5%-7%
Health Care ETF	XLV	1.64%	NA	NA	UR	NMF	91.67	5.5%-7%
Cisco	CSCO	2.80%	$56.00	Very Attractive	3	0.83	46.35	4%-5.5%
Intel	INTC	2.38%	$51.00	Attractive	3	1.03	52.67	4%-5.5%
Johnson & Johnson	JNJ	2.91%	$151.00	Attractive	4	0.89	133.66	4%-5.5%
Booking Holdings	BKNG	0.00%	$2158.00	Highest Rated	6	0.93	2014.39	2.5%-4%
Dollar General	DG	0.81%	$125.00	Attractive	4	1.30	162.05	2.5%-4%
General Motors	GM	3.89%	$48.00	Attractive	3	0.76	36.24	2.5%-4%
PayPal	PYPL	0.00%	$125.00	Attractive	3	0.82	102.79	2.5%-4%
Vanguard REIT ETF	VNQ	3.29%	NA	NA	UR	NMF	92.90	2.5%-4%
Cash consideration	-	-	-	-	-	-	-	**10.0%**

UR = Under Review
This portfolio is not a real money portfolio. Data as of October 15, 2019.

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

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

Every person has different goals and different risk tolerances, so where before in the 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.

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.

*5 Questions…*from page 7

ANSWER: On October 2, we published a note covering why the near-term outlook for Zimmer Biomet (ZBH) was less optimistic than management would have you believe. Here's a slightly edited excerpt from the piece:

> *"Previous guidance for 2019 called for -0.5% to 0.5% annual revenue growth assuming a 100-150 basis point headwind from foreign currency headwinds… **Now management expects the foreign currency headwind to come in at 125-175 basis points in 2019; however, Zimmer Biomet still raised its revenue growth guidance to flat to 0.5% growth.***
>
> *Non-GAAP revenue was up 1% on a constant currency year-over-year basis during the first half of 2019, but down 1.5% on a GAAP basis when including foreign currency headwinds. **It's a little odd that management guided for stronger top line growth while assuming a larger foreign currency headwind considering the relatively weak sales performance during the first half of the year.** Not out of the question by any means, but suspicious…*
>
> *Management lowered Zimmer Biomet's full-year adjusted (non-GAAP) operating profit margin expectation to 27.0-27.5% from 27.0-28.0% previously, while also lowering its expected adjusted tax rate by 50 basis points. Peculiarly, however, the company raised its full-year adjusted (non-GAAP) diluted EPS guidance to $7.75-$7.90 from $7.70-$7.90 previously…*
>
> ***…the company's upwardly revised adjusted diluted EPS forecast for 2019 is entirely based on slightly stronger expected revenue growth (a forecast that looks a tad overly optimistic given weak first half performance and rising foreign currency headwinds) and a lower adjusted tax rate offsetting the negative impact of a lower expected operating profit margin.** In particular, the lower adjusted expected tax rate is quite convenient and could be viewed as management front-loading certain tax shielding strategies in a bid to preserve Zimmer Biomet's perceived near- and medium-term outlook."*

To reiterate our view, we think there's a good chance management will deploy aggressive tax shielding efforts during the second half of 2019 to bolster Zimmer Biomet's EPS this year by reducing its effective tax rate, **but that doesn't change the headwinds its business faces.** For instance, the US Supreme Court on Monday October 7 struck down Zimmer Biomet's request to appeal a $248 million judgement made against the firm. That ruling involved Zimmer Biomet infringing on some of the intellectual property of competitor Stryker Corporation (SYK) as it relates to patents covering surgical cleaning wands. The US Supreme Court opted not review the scope of the damages in the 2017 ruling, which was prompted by a 2010 lawsuit made by Stryker.

There's a chance that this legal development may embolden Stryker and other firms to file lawsuits against Zimmer Biomet in the future over patent infringement in the medical device space and that could threaten Zimmer Biomet's future financial performance if the company has to pay firms like Stryker heft fees to use their patents.

When it comes to deleveraging efforts, that's where Zimmer Biomet's management has actually been very sincere. At the end of 2015, the company had a net debt load of $9.9 billion after Zimmer Holdings acquired Biomet. By the end of June 2019, Zimmer Biomet's net debt load had fallen to $8.3 billion. However, we caution that the firm's net operating cash flows have been rather weak this year. Additionally, please note that Zimmer Biomet's GAAP operating profit dropped by almost a third from the second quarter of 2018 to the second quarter of 2019. That was largely due to rising SG&A expenses (total GAAP operating expenses climbed by 4% during this period, led by a 6% increase in SG&A expenses) and shrinking revenues.

*5 Questions…*continued on the next page

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Our models forecast strong EBIT margin growth at Zimmer Biomet over the next five years as well as modest revenue growth, so we've already captured the expected turnaround management sees in Zimmer Biomet's performance going forward (consensus estimates indicate the market expects the firm's revenue growth to begin recovering in 2020). Even when factoring in that turnaround, shares of ZBH look generously valued to us given the headwinds its business faces (from foreign currency headwinds to rising operating expenses to legal rulings negatively impacting its balance sheet and potentially its business model). Our fair value estimate for Zimmer Biomet stands at $118 per share and the top end of our fair value estimate range sits at $142 per share, with ZBH trading at $133.42 per share as of the market close on October 9. We are still staying away from ZBH. - *Callum Turcan*

3. About International and Emerging Markets Exposure

QUESTION: It is clear that our individual equity portfolios have done fantastic by applying Valuentum principles like enterprise valuation, dividend cushion etc. To further diversify portfolios, we incorporated some international, emerging markets and small cap funds--not a huge weighting to these areas, but maybe 10-20% of portfolios. These allocations have not done nearly as well. My question for you is you do not seem to advocate for a strategic allocation to developed/EM/US small cap stocks. Every investment conference I attend, the most consistent message is that allocating to these areas is super important--they say the US stocks like in Valuentum newsletter portfolios have been on a nice run but you need to diversify outside of the US. These stocks are overpriced relative to the rest of the world, carry elevated antitrust risk; plus, it's not wise to have too much of a home country bias. What's your take on this line of thinking?

ANSWER: We recently talked about the 60-40 stock-bond allocation, but we generally believe that within any allocation across any asset class that assessing the intrinsic value of the assets owned relative to their observed price is an informative process. **Modern portfolio theory may suggest greater international diversification at any price, but without adequate due diligence and a price-to-fair value process, this could result in just adding overpriced assets to a broader portfolio, which could hurt long-term returns, instead of augmenting them.** – *Brian Nelson, CFA*

4. Verizon

QUESTION: *Your summary of VZ shows a dividend cushion of 0.1, yet free cash flow seems to approximate earnings per share. If so, then the Dividend Cushion ratio would appear to be 1.56 based on EPS of $3.83? Can you explain how you come up with such a low Dividend Cushion ratio?*

ANSWER: Verizon Communications (VZ) has a strong free cash flow profile, but we caution that its enormous debt load represents the biggest reason why its Dividend Cushion ratio is so low at 0.1x. **Our Dividend Cushion ratio is based on the forecasted net operating cash flows of the firm over the next five full fiscal years, less expected capital expenditures during this period (effectively the company's expected free cash flows during this period), less the net debt (or plus the net cash) position of the firm at the end of its most recent fiscal year, dividend by the expected total dividend payout during this period.**

Our two-page Dividend Report, which can be accessed through the relevant ticker webpage on Valuentum's website (the symbol/keyword search bar is situated at the top righthand corner of the screen), offers visual breakdowns of the Dividend Cushion ratio in action. We see free cash flows as the true source of funds for dividend payouts (cash raised through other means, such as debt issuances, aren't a sustainable proposition), and recognize that net debt loads compete with dividends over future use of free cash flows. More broadly, the income statement provides just an estimation of a company's financial health, while the cash flow and balance sheet statements provide investors with a better picture of what's actually going on inside the company. In the graphic at the top of the next page (Page 11), we highlight why Verizon's Dividend Cushion ratio is relatively low. – *Callum Turcan*

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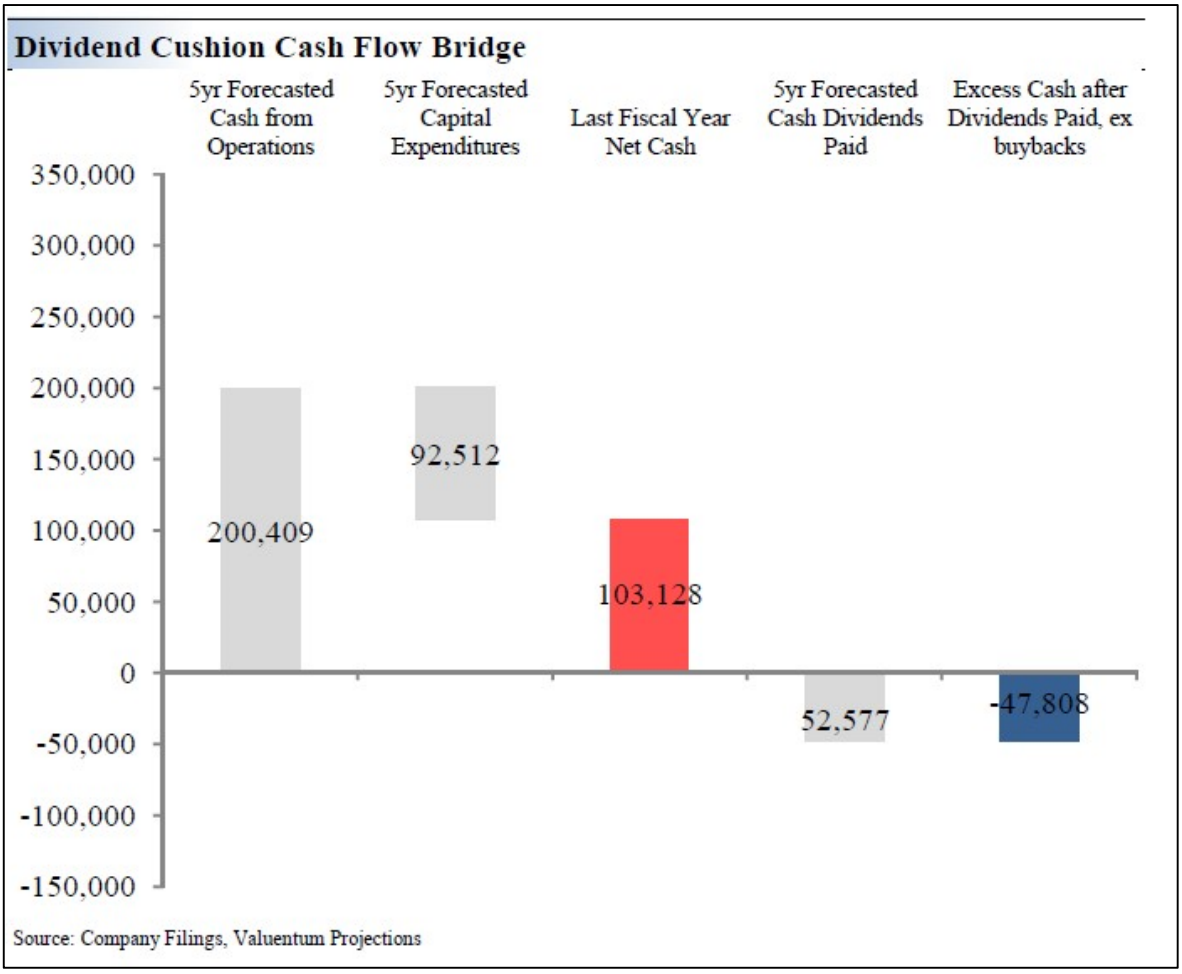

***Image Shown**: Verizon's Dividend Cushion ratio is weak because of the firm's large net debt load and sizable expected capital expenditures, a product of the telecommunications giant getting ready to rollout out 5G infrastructure across the US.*

5. About the Quant Value and Size Factors

QUESTION: There seems to be some diversification benefit over the last 30 years to incorporating international investments, but this has diminished over time. Moreover, SmB (size) factor is negative for S&P 500 over 30 years and HmL (value) is flat. Seems like these are better in small cap, EM and REITs, but kind of interesting.

ANSWER: We generally don't view equities in the context of realized ambiguous factors as in the HmL book-to-market ratio, for example. Our take is that the traditional quant value factor is spurious/random, and there has been additional research showing that the size effect really does not exist. From our perspective, both the CAPM and three-factor models have failed, bringing into question the entire foundation of quantitative thinking. We have very little confidence that any factor or anomaly based on realized, ambiguous data will continue into the future. **Our confidence rests in enterprise valuation (free cash flow to the firm process) and the resulting price-to-fair value (P/FV) metric coupled with a technical/momentum overlay.** *– Brian Nelson, CFA*

***Disclosure**: Callum Turcan and Brian Nelson, CFA do not own any of the securities mentioned in the article above.*

General Motors and the Union Strike!

***Image Source**: General Motors Company – IR Presentation*

By Callum Turcan

A version of this article was emailed to subscribers on October 7.

A holding in both our Best Ideas Newsletter and Dividend Growth Newsletter portfolios, shares of General Motors (GM) have come under pressure over the past month from the ongoing strike that involves roughly 46,000-48,000 of its workers (primarily in the US). So far, this strike has halted production at more than 30 General Motors facilities in the US and has negatively impacted operations at various auto parts suppliers as well. The walkout is now coming up on its second month if a deal isn't reached soon. Talks between General Motors and the Union Automobile Workers ("UAW") union reportedly took a turn for the worse over this past weekend (ended October 6) as the union rejected the auto maker's latest offer and General Motors rejected the UAW's latest deal. Negotiations are still ongoing. **Shares of GM yield 4.3% as of this writing.**

Covering the Strike

There are several points of contention between General Motors and the UAW including; **a reduction in the length of time it takes for new hires to reach the highest pay tier (from eight years to something shorter)**, finding work for a production facility in Lordstown, Ohio, and numerous facilities in Michigan (to prevent those facilities from shutting down), reducing the export of cars General Motors produces in Mexico to the US, committing to preserving existing healthcare benefits (which are some of the most generous in the industry), other pay and pension concerns, and limiting pay discrepancies for temporarily workers (who aren't necessarily entitled to profit sharing arrangements, which are very substantial at General Motors and other unionized US auto manufacturers).

Not all of these concerns can be met (it's very unlikely General Motors fundamentally alters its production operations in Mexico), but General Motors has shown a real willingness to work with the UAW on certain issues. Please keep in mind that UAW-members who work for General Motors generally are the best paid in the industry, just ahead or on-par with UAW-members who work for Ford Motor Company (F), ahead of those at Fiat Chrysler Automobiles (FCAU), and well ahead of non-union auto industry workers that predominantly are in the US South region. General Motors has committed to investing billions in the US to adapt its production capabilities to meet the needs for the 21st Century. **That means investing in electric vehicles ("EVs"), self-driving vehicles, SUVs, crossovers, and light duty trucks, and shifting production capabilities away from traditional passenger cars.**

*General Motors...*continued on next page

*General Motors…*from previous page

For instance, General Motors is reportedly contemplating converting its Lordstown plant to a battery production facility or selling that facility off to an EV start-up (which would in turn upgrade the facility). That's tied into General Motors considering having some of its Michigan production facilities (that need new vehicle iterations to stay in operation) adapted to produce EVs (presumably light duty pickups). Both moves would preserve a significant number of good-paying jobs in the US while better allowing General Motors to shift some of its production capabilities away from traditional passenger over to EVs, a win-win.

Estimated losses due to strike-related production stoppages go as high as ~$1.0 billion (as of early-October), with automotive market research provider LMC Automotive estimating General Motors' production losses stood at 118,000 vehicles through October 2. **While these headline grabbing figures are significant, what matters most is the long run impact of ongoing union negotiations.**

Cost Structure Reductions

CEO Mary Barra took over the top job at General Motors back in 2014 and set out to streamline many of the company's operations. That process involved layoffs and structural changes at the firm's production operations that are still going on to this day. Plants that were operating at just a fraction of their capacity, namely those producing passenger vehicles for US markets (which aren't in high demand as US drivers are increasingly seeking out SUVs, crossovers, and light duty trucks), began the process of shutting down as the company shifted production towards vehicles in demand. At the start of 2019, **General Motors' saw these endeavors saving between $2.0 billion - $2.5 billion this year, with material cash savings on both the operating expense (more flexible production footprint) and capital expenditure front (less underutilized production facilities to maintain) expected 2020+.**

The company is targeting North American headcount reductions of 14,000, with almost 4,000 salaried employees taking early buyout offers or having their contracts ended as of early-2019. Furthermore, please note that the entire EV production process generally requires (substantially) less labor hours than producing traditional vehicles with internal combustion engines, which should save auto manufacturers that can produce well-liked EVs (meaning those that adapt early enough to take meaningful market share in the EV space) enormous sums in the long run.

General Motors already has the Chevy Bolt offering, and longer term, the company plans to also use its luxury Cadillac brand to help build the necessarily production infrastructure (battery plants, new and upgraded auto plants, and charging station networks) to support material levels of EV sales in the future (EV sales are still a relatively small part of the global automobile market as of 2019). At the beginning of this year, General Motors teamed up with a group of companies to support the rollout of EV charging station networks in the US. We think General Motors' all-electric Cadillac offerings could pose a serious threat to rival Tesla Inc (TSLA), especially as Cadillac targets the more lucrative SUV/cross-over market.

Assuming General Motors stays the course, we are still very optimistic on its forecasted free cash flow growth. **While shares of GM have taken a hit over near-term headwinds, the company continues to deliver on what matters most and that's serious cost structure improvements (the result of production rationalization, a must in the industrial world).** We are late in the business cycle and sales of US automobiles likely peaked a couple of years ago, however, please keep in mind most of the value of equities comes from the mid-cycle and the perpetuity (forecasted free cash flows, discounted at an appropriate rate, in the Year 5+ period). The cost improvements CEO Mary Barra has secured so far has had a powerful uplifting impact on General Motors' forecasted free cash flows. Highlighted in the graphic at the top of the next page (Page 14) is General Motors' expected free cash flow trajectory over the next five fiscal years from our 16-page Stock Report covering the company.

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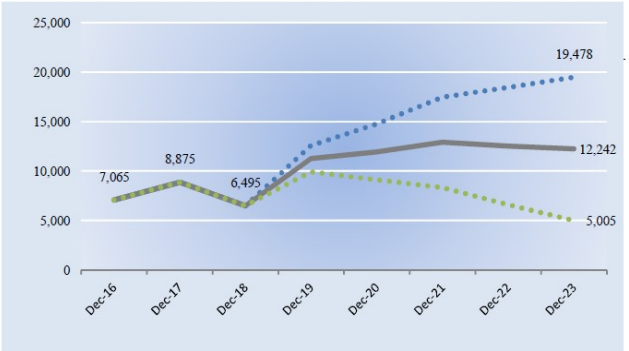
General Motors...from previous page

Free Cash Flow (CFO-capital expenditures)

		Last Fiscal Year FCF	3-year Historical CAGR	5-year Projected CAGR
General Motors	USD	**6,495**	**56.9%**	**13.5%**
Ford	USD	7,237	-7.1%	6.8%
Harley-Davidson	USD	992	5.7%	-4.8%
Honda	JPY	415,181	44.6%	11.2%
Toyota	JPY	2,918,892	4.8%	6.8%
Peer Median			5.2%	6.8%
Industry Median			5.2%	6.8%

General Motors' free cash flow expansion has been greater than that of both its peer group and industry group during the past three years. We expect the firm's free cash flow expansion to outpace its peer group and industry group during the next five years. General Motors sports the highest expected free cash flow growth rate among peers.

Projected Free Cash Flow (in millions of USD) Source: Company Filings, Valuentum Projections



In the chart above, we show our baseline forecast for free cash flow as well as potential upside and downside cases.

***Image Shown**: Please note that under our base case scenario, we expect meaningful free cash flow growth at General Motors. Cost structure improvements play a key role in supporting this trajectory, with GM Cruise and EVs offering long-term upside in terms of new revenue growth opportunities.*

Farther out, General Motors' stake in autonomous vehicle venture GM Cruise highlights the auto maker's ability to effectively invest in less conventional growth markets. The rollout of a commercial-level self-driving taxi service was delayed past 2019 as more work still needs to be done given the regulatory and engineering complexity of such an offering, but many in the industry still see the venture as one of the leaders in the self-driving world. GM Cruise has received backing from entities like Honda Motor Co (HMC) and SoftBank Group (SFTBY), raising ~$7.25 billion in the past year or so.

Concluding Thoughts

We like General Motors' dividend coverage and its Dividend Cushion ratio stands at a healthy 3.5x after making certain adjustments (unadjusted, General Motors' has a Dividend Cushion ratio of 1.3x given its large financial segment). **Our fair value estimate for shares of General Motors stands at $48 per share, well above where GM is trading at as of this writing.** We continue to like the name and will be monitoring ongoing UAW-GM talks very closely going forward.

***Disclosure**: Callum Turcan does not own any of the companies mentioned above.*

Economic Commentary: Robots, *Value Trap*, and Politics on the Markets

By Valuentum Analysts

Valuentum sat down for the latest installment of its periodic economic commentary, and the team tackled a wide array of topics, from robots on Wall Street, to President of Investment Research Brian Nelson's new book *Value Trap*, to political influence on the markets and boyond. Let's set the stage with a prompt from a recent Bloomberg article, "The Master of Robots…Coming for Wall Street:"

> "The problem is, computer-powered strategies are struggling to live up to the hype, with a Eurekahedge index of AI hedge funds lagging peers in recent years. That spells opportunity for the likes of Lopez de Prado with his outfit True Positive Technologies -- **a dig at the erroneous conclusions derived from data that are rampant among quants, or false positives.**
>
> His diagnosis: Fund managers are routinely throwing data at a robot without forming a theory. If a backtest suggests investors should snap up stocks on a given day of every month and sell them a number of days later, only a joined-up rationale for the trade will work in live markets…"

Economic Commentary...continued on next page

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> …In the other extreme, economist-led quants have a penchant to use machines in order to confirm pre-existing ideas, he reckons. One way to fix all this is to use the technology to develop core propositions -- the scientific way. "**Without this theory-ML interplay, investors are placing their trust on either toy models or high-tech horoscopes,"** Lopez de Prado wrote in a recent paper.

Callum Turcan: There seems to be a growing chorus of those that think quant and AI-driven trading strategies are largely marketing schemes to boost assets under management ("AUM") masquerading as potential ways to generate alpha. Not having a theory when making trading or investing decisions means when things get tough, those traders/investors will have weak hands and no conviction in their positions.

Matthew Warren: I am in complete agreement about weak hands. If and when the markets go "haywire," and quant fund losses mount, they have a tendency to turn off the trading machine. Volumes drop and volatility only increases. **Trading without a hypothesis of some kind seems moronic to me.** It begs the belief that it is being done in size.

Brian Nelson: Since the publishing of *Value Trap*, we are already starting to see many changes in the investment landscape. Berkshire's abandoning of book value as a key metric in its latest annual report, executive teams scaling back buybacks, now some 110 distribution cuts across the MLP universe, key pipeline players putting free cash flow next to distributable cash flow in press releases, and now perhaps the biggest: **one of the top quants on Wall Street emphasizing the importance of theory over data mining.**

While I would like to think that *Value Trap's* influence is causing these positive developments, in some ways, it is just a matter of common sense, and Valuentum getting ahead of developments is just part of good research. [That said, given some of the sales trends that I've been witnessing with the book, it is possible that *Value Trap* may have had something to do with a few of these new developments.] When it comes to quant today, I think a lot of investors simply don't believe that many are trading on spurious correlations developed through data mining, but it is more prevalent than one thinks.

The explosion of the terms "evidence-based" and "empirical" during the sales process, for example, almost by definition involves some torturing of the data and likely a number of false positives with the conclusions, especially if the data analysis isn't preceded by theory. Most of the Chicago school is empirical sans theory, for example. Professor Marcos Lopez de Prado, one of the top quants on Wall Street emphasized the importance of theory setting the parameters instead of the 'oracle' approach (data mining). As he said, without theory, quant and machine learning is just playing with "toy models" or reading "high tech horoscopes."

The reality is that the influence of the three-factor model as the seminal work on factor investing has spawned some 300+ factors developed in similar fashion by academia, and almost all, if not all of them, are spurious. **Nobel laureate Richard Thaler, for example, wrote in Misbehaving that Fama and French have all but conceded "that they did not have any theory to explain why size and value should be risk factors."** Today, not only is the traditional quant value B/M metric failing, but recent work indicates the size effect doesn't really exist either--and the CAPM has been dead for almost three decades now.

The issue with quantitative research comes down to the preponderance of false positives, of which HmL and SmB are likely, brought about by data mining via backtests. The theories or hypothesis tend to come after the data analysis, not before, in somewhat of a Texas Sharpshooter fallacy. How is this conversation relevant to the individual investors, and why should they be paying attention? Well, for starters, it's easy for the layman to understand that it doesn't matter how much theory comes after showing that avocado prices are highly correlated to Bitcoin returns; they know the relationship is still spurious. It's obvious.

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Brian (continued): But it's not as easy for the layman to understand the same thing about B/M and size, for example – two items almost completely irrelevant to the valuation equation in enterprise valuation. B/M and size are what I describe as "believable" false positives (which are more dangerous than obvious ones like the avocado/Bitcoin example), and it's not just this factor or that factor; it is pretty much all of them that are based on realized, ambiguous data. The application of realized ambiguous data, if used as explanatory variables, likely makes the entire regression wrong, or if not, certainly less useful. **Putting theory first in quant and machine learning means that it is expected, unrealized data that matters--forward-looking expectations that may or may not come to fruition. That's what drives prices and returns.**

Data mining has become extremely problematic to the industry, and my belief is that its influence is not only the source of the "empirical" and "evidence-based" sales processes that are being pitched to individual investors when it comes to index investing (and the growth of factor research and investing), but also I believe that many in active management have been "wrongly" influenced by these failed quantitative processes, and it has manifested itself into severe active fund underperformance.

Certainly, we can point to a lot of reasons why 90% of active management has failed during the past 10-15 years, but quant's influence (as revealed by its proliferation), in my view, is one of them. **Large cap growth stocks have outperformed small-cap value stocks by 37 percentage points during the past decade or so (exactly the opposite of what a quant might have expected when the three-factor model was published in the early 1990s).** Anyone that says quant's influence on the industry hasn't impacted active fund underperformance isn't calling it straight, in my view.

Callum: What I find interesting is that active managers, according to a recent JPM report "Active Management and QE-Distorted Markers", tend to perform relatively better (versus the relevant benchmark) in down markets as compared to markets in a decade-long upward trend. As we got later into the latest business cycle, a growing number of active fund managers seem to have struggled in finding alpha, which I would argue is at least partially due to price-agnostic trading bidding up most equity values in the post-Great Financial Crisis world. It's harder to outperform when everything appears to be increasing in value, and the only right call was to be long bond-proxies (REITs, utilities) and secular growth names (large tech and payment processing companies).

Switching gears a bit, a recent article from CNBC covered the 2020 presidential race side of things and how that could, potentially, be impacting recent market movements (i.e. weakness in financials or in certain areas of the healthcare sector). One never wants to put too much emphasis on short-term market movements as causation and correlation are two different beasts, especially when emotionally charged political views/calculations are at play, but something to keep in mind given the dichotomy the 2020 presidential election will likely pose as it relates to the trajectory of economic policy in the US.

Brian: Without a doubt, the political cycle will be a source of market volatility as we head deeper into the 2020 election cycle. Democratic candidate Bernie Sanders' campaign may be facing heightened pressures given health concerns, and this may play into the hands of Elizabeth Warren, increasing her chances as the Democratic choice. Recent polls put her ahead of Joe Biden, and I think developments in the Sanders' campaign may have more to do with that than anything else. There's still a long road ahead until we get to the brunt of the election cycle, but it looks like Warren is now the frontrunner to face President Trump.

Going back to the election of President Trump in 2016, the markets sold off aggressively, but then rebounded at a considerable pace. Speculating on the direction of stock prices as a result of who wins the next election may be largely a fools' errand, as there's a lot more at work than who is in the Oval Office. That said, I do believe this bull market will be severely challenged in the event that a Democrat takes office given some of the progressive items on the agenda. Regardless of whether it is Biden, Warren, Sanders, Trump or even Hillary Clinton that takes office next term, however, this bull market is long in the tooth, and considerable risks are mounting.

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Callum: In particular, I think the healthcare (XLV, IBB) sector could be in for a lot more pain (at least in terms of technical performance heading into election season, if it hasn't started already) as we enter 2020 given the paradigm-shifting risks a Warren or Sanders presidency would pose to the space (as it relates to price setting across the entire drug making, hospital, doctor, and insurance industries, on top of the ability to negotiate prices with the government or the lack thereof, length of exclusivity for drugs, regulatory burdens, tax rates at-large, etc.).

Matthew: Unless the Democrats are able to capture the Senate in addition to the Presidency, I think some of the bolder plans won't make it past the talking stage. That said, there seems to be a groundswell amongst the populace to increase access and lower the costs of healthcare. For example, there could certainly be bipartisan action against drug company pricing power.

In other news, Moody's came out with a report saying that the "next recession may lower 10-year Treasury yield to range of 0.5% to 1%." If they are right about where rates are going in the next recession, and I have no reason to argue with the hypotheses, then there will be that much more money moving into bond proxies such as high yielding "safe" dividend paying stocks (SDY).

Callum: On your point regarding bipartisanship and potential changes to the structure of the US healthcare space Matt, assuming a Warren White House, Democratic House of Representatives, and a Republican Senate, I do think there's at least a chance that some legislation could get pasted regarding controlling drug prices (or at least attempting to via government regulatory schemes). Pharmaceuticals and pharmaceutical benefit managers ("PBMs") would likely get hurt should this particular scenario arise, but only to a modest degree relative to what would likely occur should a complete takeover by the US Democratic party materialize. It's a tall order in the US Senate.

Regarding the Moody's piece, it mentions the chances of either a 25 basis point or 50 basis point cut at the upcoming FOMC meeting (October 29-30), with market participants clearly seeing the chance of a 25 basis point cut as extremely likely (far less so for a 50 basis point cut). After the decent jobs report for September 2019 (136,000 jobs added, 2.9% year-over-year average hourly earnings growth, reduction in U-6 unemployment rate from 7.2% to 6.9% on a sequential basis, reduction in U-3 unemployment rate from 3.7% to 3.5% on a sequential basis), a 50 basis point cut seems off the table in my view while a 25 basis point cut is still very much on the table.

That's due in part to the slowdown in US services activity that was reported recently (ISM Non-Manufacturing Index for the US dropped from 56.4 in August 2019 to 52.6 in September 2019, which was down sharply from 60.8 in September 2018), with services representing the key economic growth driver for the US so far this year. Additionally, US job growth in 2019 has slowed down substantially from 2018 levels (by ~25-30% according to the *Wall Street Journal*). In my view, the Fed will likely want to push through additional incremental insurance rate cuts (meaning increments of 25 basis points) to offset exogenous headwinds and maintain market stability (made easier by pushing through smaller rate cuts in a consistent manner instead of deeper rate cuts at an inconsistent rate).

With respect to the lower bound yield for ten-year US Treasuries that Moody's forecasted and highlighted, there are a lot of moving parts here. How the US-China (FXI, MCHI, KWEB) trade war, Korea-Japan (EWJ) trade war, Russia-West (RSX) tensions, Brexit, upcoming European elections in Germany (EWG) and France (EWQ), the 2020 US election, and much more plays out will have a tremendous impact of the trajectory of global economic growth over the coming decade(s), which in turn will have a powerful impact on the trajectory of US economic growth during this period. While a slowdown and potentially a recession seems to be coming up for the US, how quickly we bounce back will be dependent on a lot of factors one can't predict with absolute certainty.

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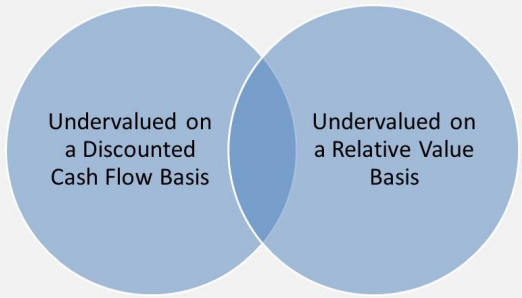
https://www.valuentum.com/articles/Economic_Commentary_Robots_Value_Trap_Politics_on_the_Markets

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 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 the newsletter portfolios.

Company Name	Symbol	Industry	DCF Valuation	Relative Valuation	Price / Fair Value
FedEx	FDX	Air Freight & Logistics	UNDERVALUED	ATTRACTIVE	0.76
Harley-Davidson	HOG	Auto Manufacturers	UNDERVALUED	UNATTRACTIVE	0.79
Lear Corp	LEA	Auto Parts Suppliers	UNDERVALUED	ATTRACTIVE	0.67
Discover Financial	DFS	Banks & Money Centers	UNDERVALUED	UNATTRACTIVE	0.78
Verint	VRNT	Business Services	UNDERVALUED	NEUTRAL	0.79
Mosaic	MOS	Chemicals - agriculture	UNDERVALUED	ATTRACTIVE	0.77
SMART Global Holdings	SGH	Computers & Peripherals	UNDERVALUED	NEUTRAL	0.70
Owens-Illinois	OI	Containers & Packaging	UNDERVALUED	ATTRACTIVE	0.63
Fluor	FLR	E&C	UNDERVALUED	ATTRACTIVE	0.65
LG Display	LPL	Electronic Suppliers	UNDERVALUED	UNATTRACTIVE	0.79
CVS Health	CVS	Food Retailers	UNDERVALUED	NEUTRAL	0.68
AmerisourceBergen	ABC	Healthcare Products	UNDERVALUED	ATTRACTIVE	0.78
Cardinal Health	CAH	Healthcare Products	UNDERVALUED	ATTRACTIVE	0.65
Continental Resources	CLR	Independent Oil & Gas	UNDERVALUED	ATTRACTIVE	0.65
EOG Resources	EOG	Independent Oil & Gas	UNDERVALUED	NEUTRAL	0.74
Stamps.com	STMP	Internet & Catalog Retail	UNDERVALUED	NEUTRAL	0.59
DXC Technology	DXC	IT Services	UNDERVALUED	NEUTRAL	0.65
Tapestry	TPR	Luxury - Ultra & Aspirationa	UNDERVALUED	ATTRACTIVE	0.79
AK Steel Hldg	AKS	Metals & Mining - steel	UNDERVALUED	NEUTRAL	0.48
Hillenbrand	HI	Personal Services	UNDERVALUED	ATTRACTIVE	0.79
Gilead Sciences	GILD	Pharma - Generic/Other	UNDERVALUED	NEUTRAL	0.73
Mylan	MYL	Pharma - Generic/Other	UNDERVALUED	NEUTRAL	0.63
Ebix Inc	EBIX	Software	UNDERVALUED	ATTRACTIVE	0.56
AutoNation	AN	Specialty Retail - auto	UNDERVALUED	ATTRACTIVE	0.73

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.

AmeriSourceBergen (ABC) is the only company in our coverage that registers either a 9 or 10 on the Valuentum Buying Index at this time (the best rating). Please note that we passed on adding ABC to the newsletter portfolios.

Company Name	Symbol	Sector	Industry	VBI
Mondelez Intl	MDLZ	Consumer Staples	Food Products - Large	1
RBC Bearings	ROLL	Industrials	Machinery & Tools	1
Mettler-Toledo	MTD	Health Care	Medical Instruments	1
Bright Horizons Family	BFAM	Consumer Discretionary	Personal Services	1
Brown-Forman	BF.B	Consumer Staples	Beverages - alcoholic	2
Diageo	DEO	Consumer Staples	Beverages - alcoholic	2
Ecolab	ECL	Materials	Chemicals - broad	2
Amphenol Corp	APH	Information Technology	Electronic Suppliers	2
Corning	GLW	Information Technology	Electronic Suppliers	2
Dolby	DLB	Information Technology	Electronic Suppliers	2
Waste Connections	WCN	Industrials	Environmental Services	2
MBIA Inc	MBI	Financials	Insurance - Property & Casualty	2
Selective Insurance	SIGI	Financials	Insurance - Property & Casualty	2
LVMH	LVMHF	Consumer Discretionary	Luxury - Ultra & Aspirational	2
Graco	GGG	Industrials	Machinery & Tools	2
McDonald's	MCD	Consumer Discretionary	Restaurants - Fast Food & Coffee	2
Starbucks	SBUX	Consumer Discretionary	Restaurants - Fast Food & Coffee	2
Synopsys	SNPS	Information Technology	Semi Equipment	2
VeriSign	VRSN	Information Technology	Software - security	2
Allete	ALE	Energy	Utilities	2
MGE Energy	MGEE	Energy	Utilities	2
Sempra Energy	SRE	Energy	Utilities	2

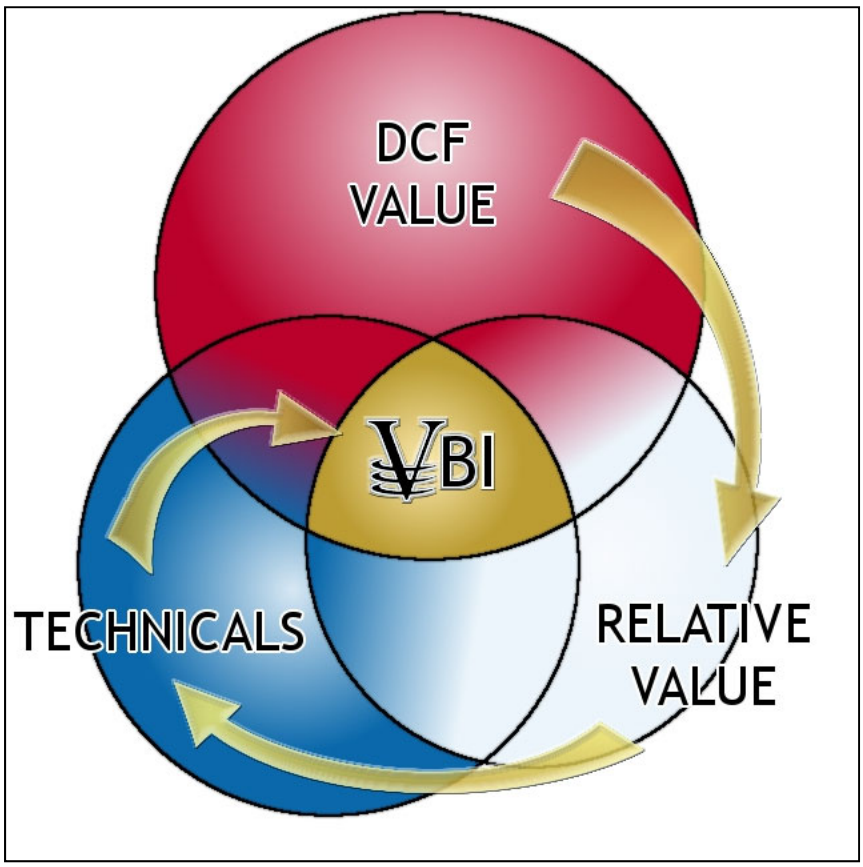
*Ideas...*continued on next page

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.

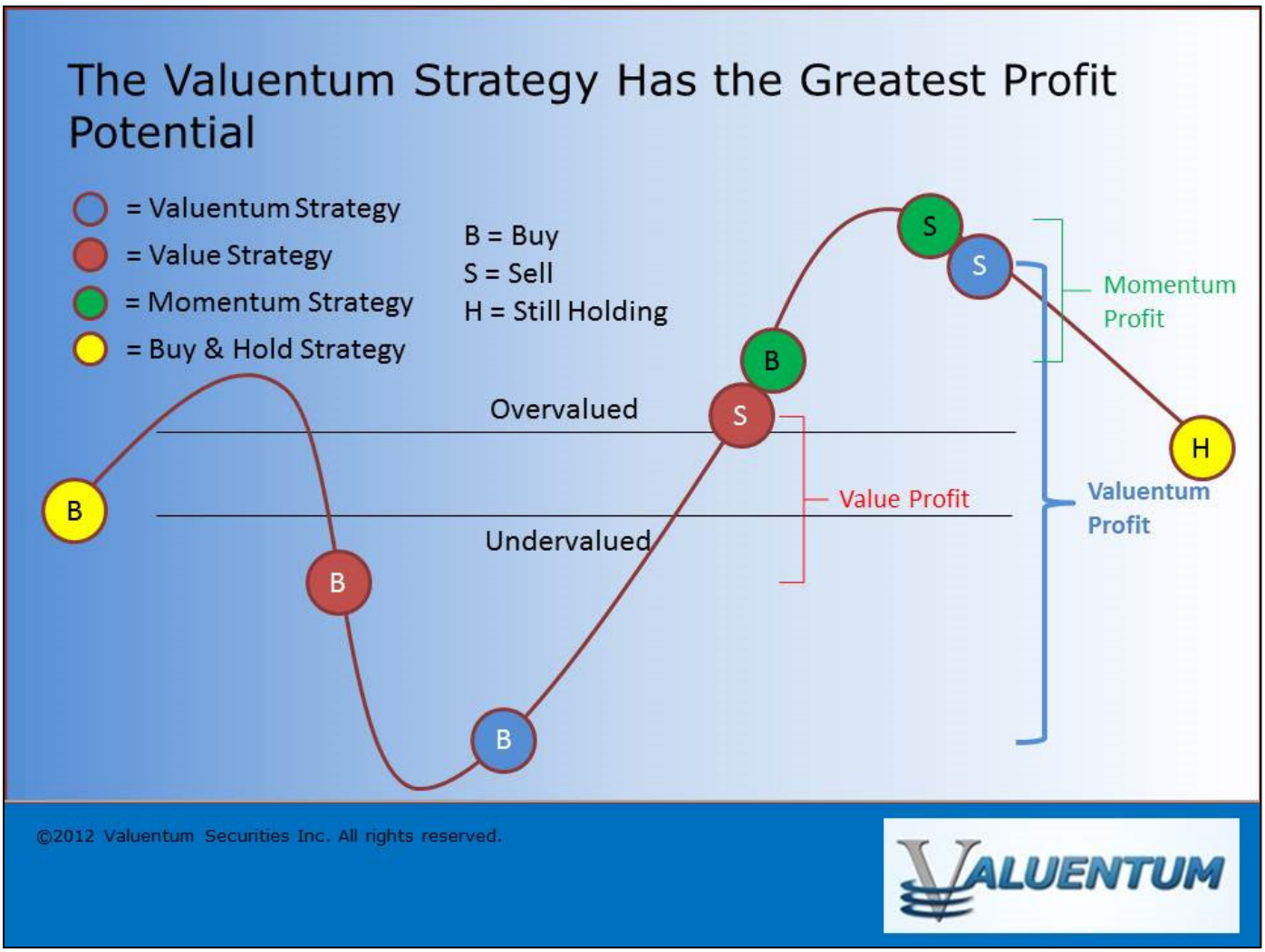


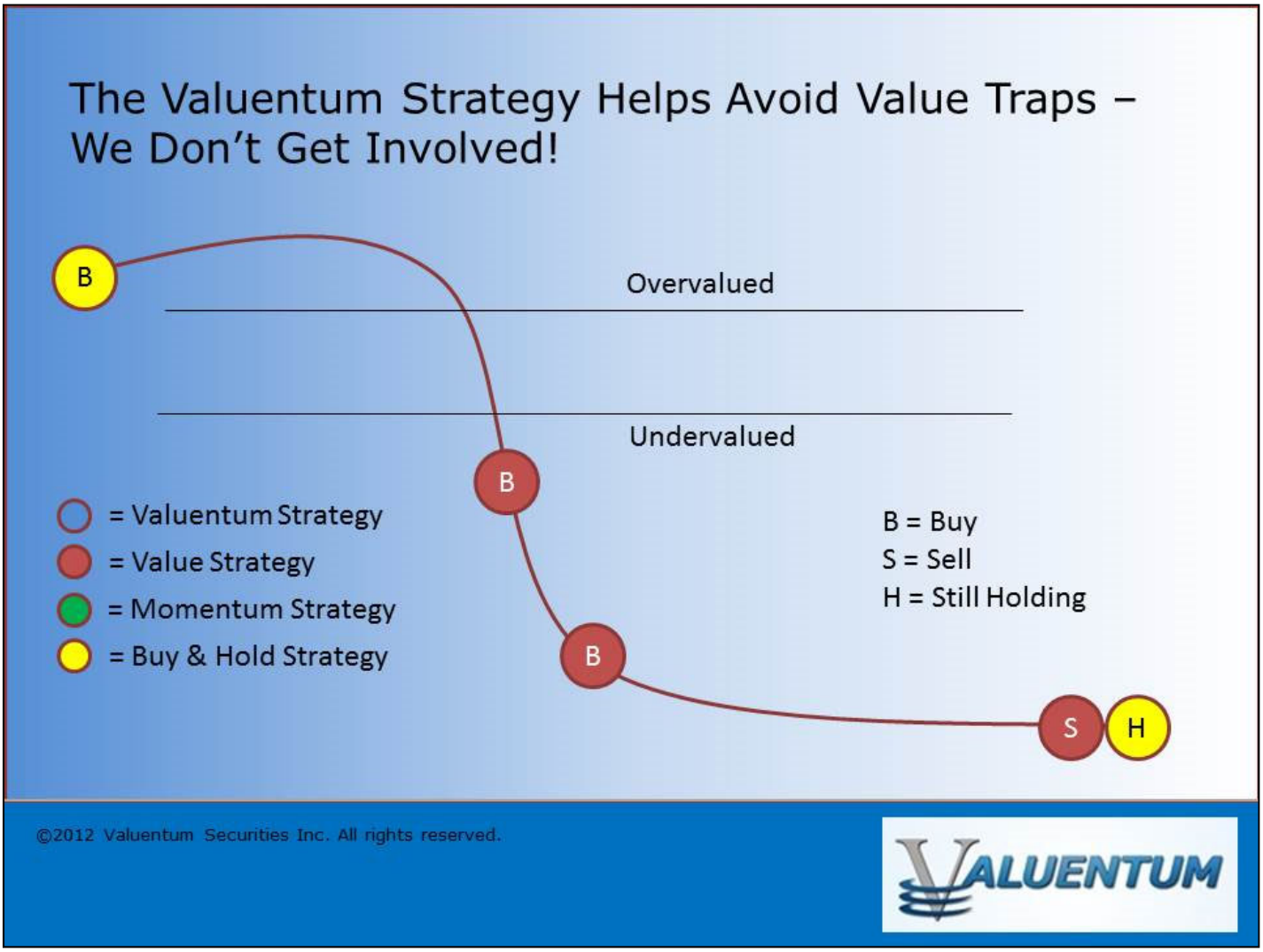
Illustration for educational purposes only.

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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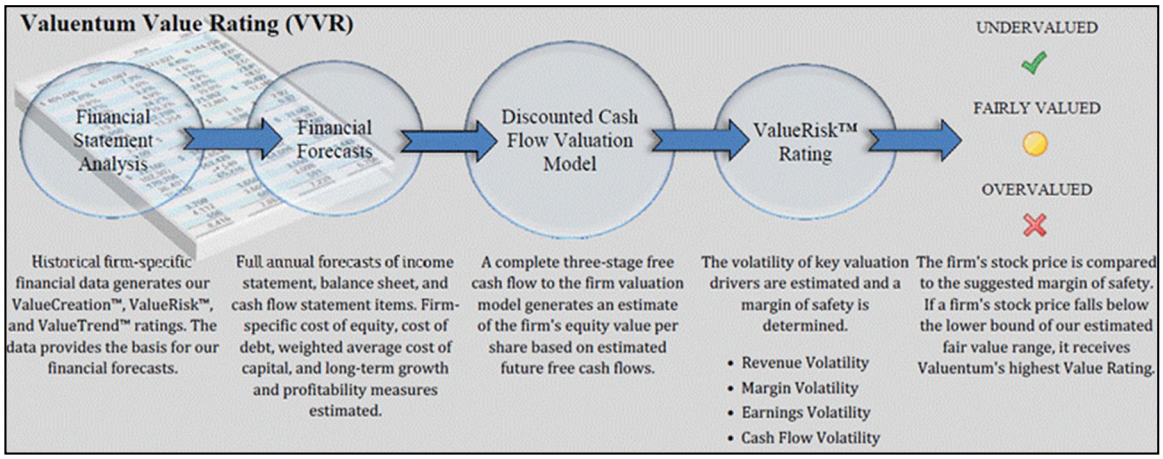
Our Methodology – The Valuentum Buying Index continued on next page

Our Methodology – The Valuentum Buying Index continued from previous page

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

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

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



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

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

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

Our Methodology – The Valuentum Buying Index continued on next page

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

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

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

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

Our Methodology – The Valuentum Buying Index continued on next page

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valuation criteria).

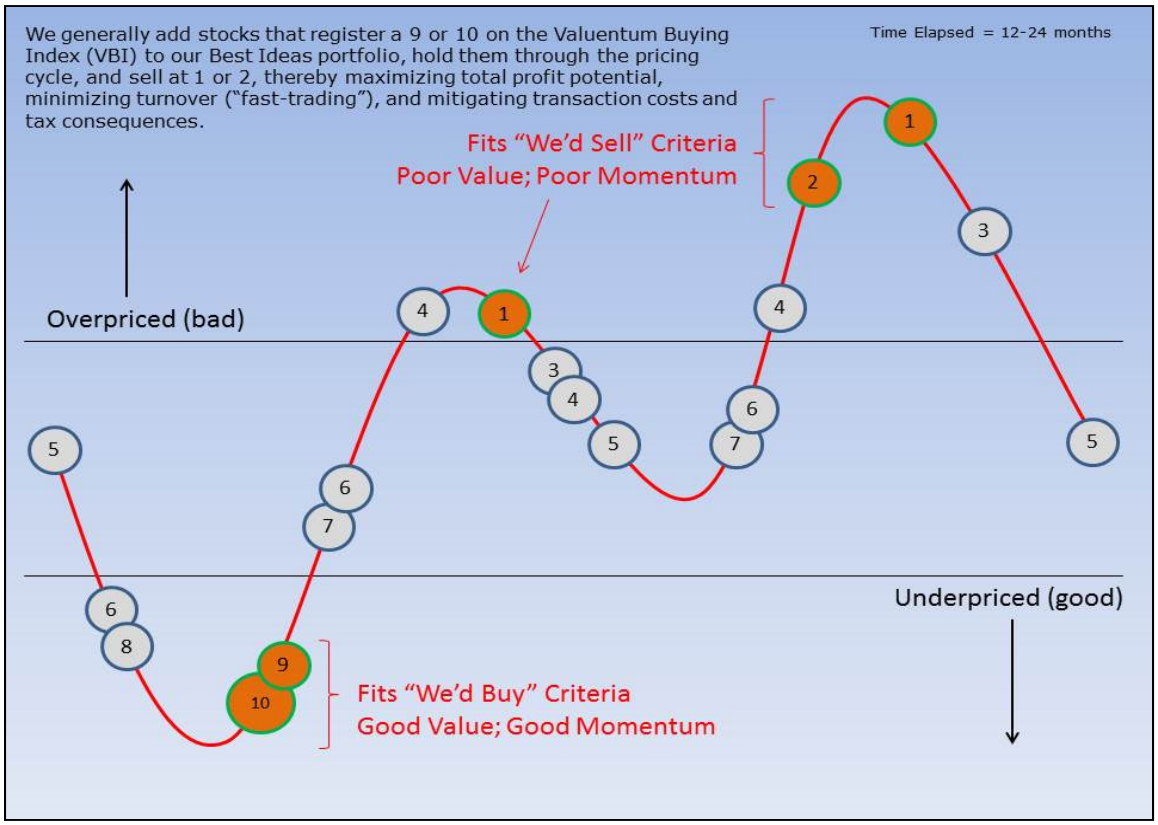
Rigorous valuation analysis and technical analysis are not mutually exclusive, and we believe both can be used together to bolster idea generation. An evaluation of a stock's moving averages, relative strength, upside-downside volume, and money flow index are but a few considerations we look at with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

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

Putting It All Together - the Valuentum Buying Index

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

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



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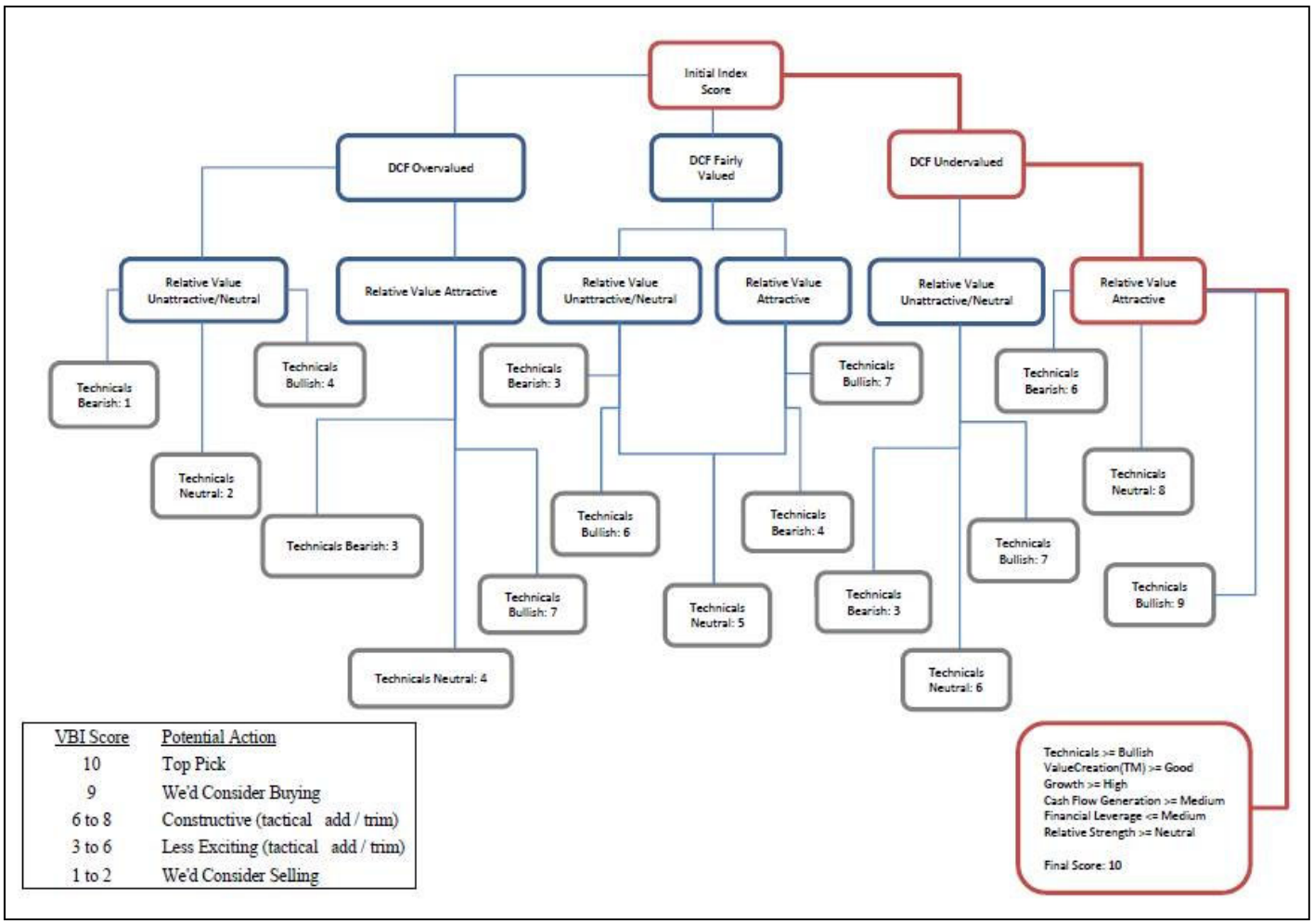
Let's follow the red line on the flow chart below to see how a firm can score a 10, the best mark on the Valuentum Buying Index (a "Top Pick"). Please click here to view an enlarged pdf version.

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

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



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Our Methodology – The Valuentum Buying Index continued on next page

About the Fair Value Range

By Valuentum Analysts

Understanding the Fair Value Range and Why It's Important

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

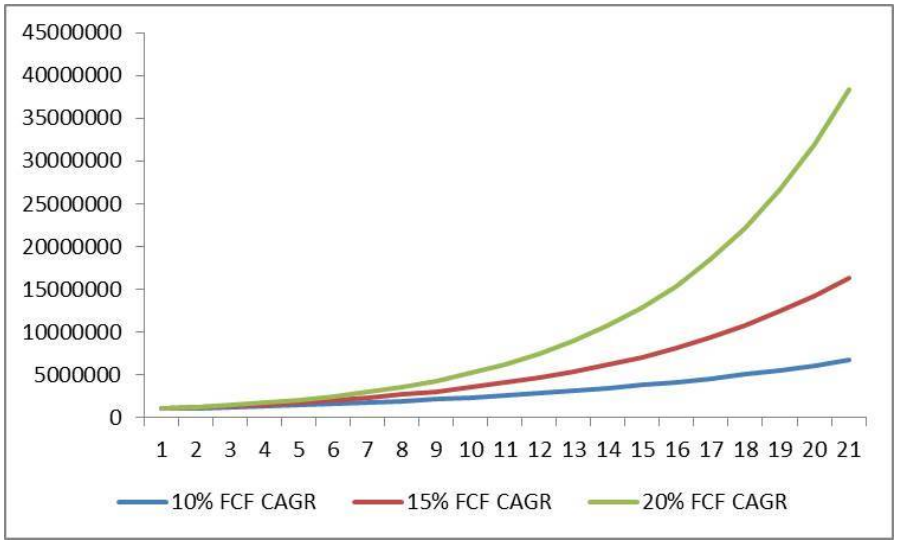
One of the most important concepts of the Valuentum methodology (and valuation in general) is the understanding that the value of a company is a range of probable valuation outcomes, not a single point estimate. Even well-seasoned stock analysts are guilty of saying that a company's shares are worth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

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

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

But why the large range in many cases?

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



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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.

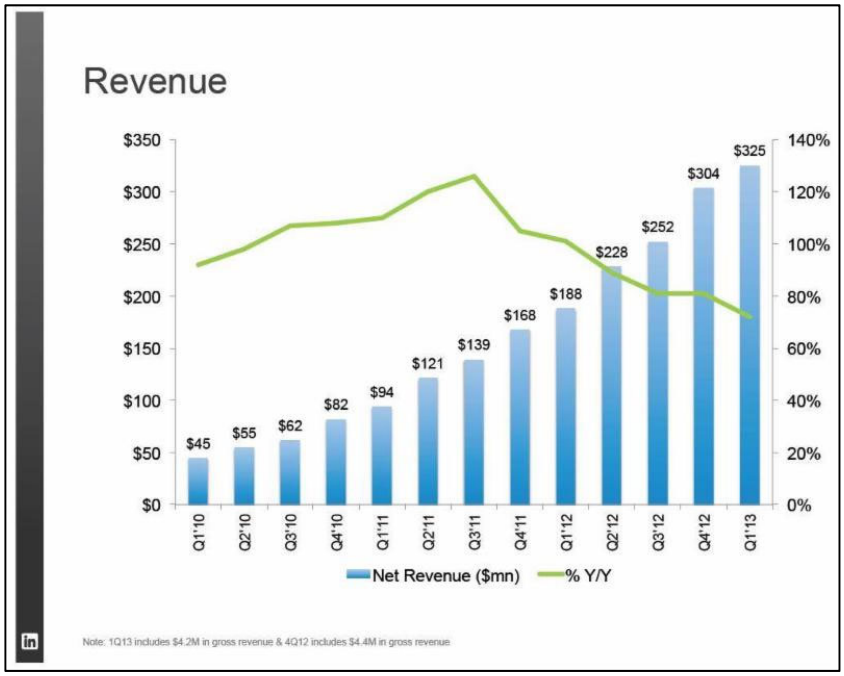


Image Source: LinkedIn

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

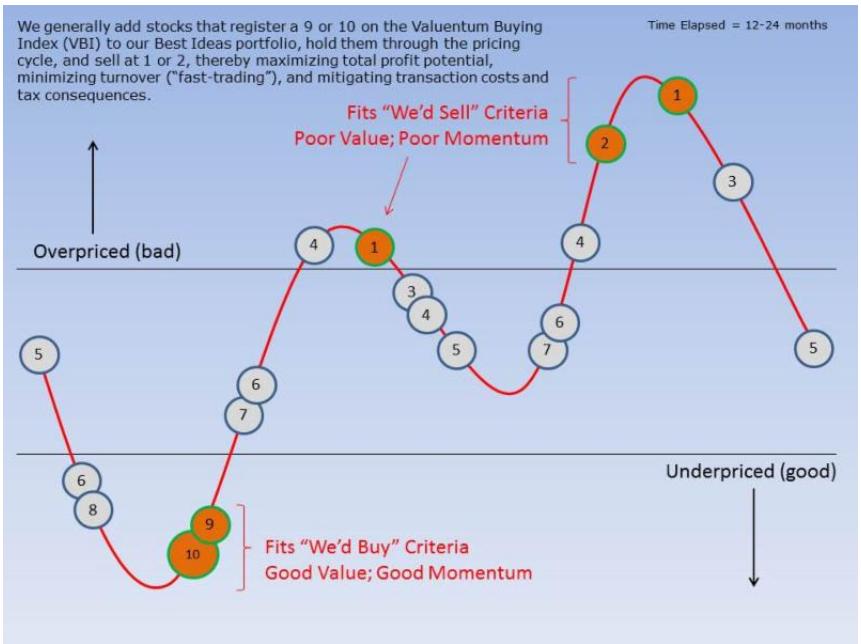
may be the secret to success in investing, a lot could have gone wrong with the temptation to do something each day. Obviously, we're very disciplined, but we also credit the portfolio outperformance to the VBI methodology itself. It is a very helpful tool.

** 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

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

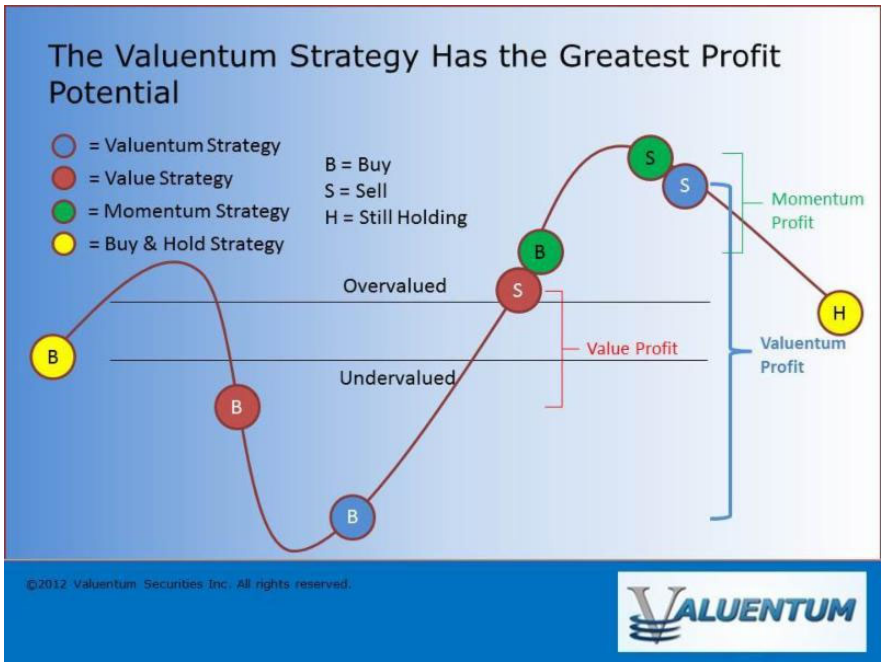

Image shown for informational/illustration purposes only. Valuentum is an investment research publishing company.

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.

Valuentum Best Ideas Newsletter: Volume 9, Issue 10

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