OUR BEST IDEAS NEWSLETTER

# Valuentum Securities

Stock Analysis: From Value through Momentum Investing

November 15, 2019
Volume 9 Issue 11

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

**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)

## Inside This Issue

1 Berkshire Hathaway Reports Solid Third Quarter Performance
4 PayPal Posts a Blowout Quarter
7 Asset Light, Free-Cash-Flow Generating Powerhouse Bookings Holding (Priceline) Remains One of Our Favorite Ideas
8 **Best Ideas Newsletter Portfolio**
10 Intel Still One of Our Favorite Ideas
14 Proctor & Gamble Appears Overvalued
17 Amazon Contends with Rising Operating Expenses and Shrinking Gross Margins
18 The Watch List
20 About the Valuentum Buying Index
27 About the Fair Value Range
30 How We Use the Valuentum Buying Index in the Newsletter Portfolio

"Chances of a narrow US-China trade deal getting finalized by December are fading fast as negotiations falter once again. Even the location is tough to agree upon, given the optics of a potential signing ceremony."

- Callum Turcan

© 2019 Valuentum. All rights reserved.
Reproduction by any means is prohibited.

# Berkshire Hathaway Reports Solid Third Quarter Performance

***Image Shown:*** *Shares of Berkshire Hathaway Inc moved higher on Monday November 4 after reporting a decent third quarter 2019 earnings report on Saturday November 2.*

*By Callum Turcan*

Berkshire Hathaway Inc (BRK.A) (BRK.B) reported solid third quarter 2019 earnings on November 2, and we continue to like Berkshire Hathaway Class B shares as a top holding in our Best Ideas Newsletter portfolio. Our fair value estimate for BRK.B stands at $229 per share with room for upside, as the top end of our fair value estimate range sits at $275 per share.

### Third Quarter Overview

**We would like to highlight up front that Berkshire Hathaway's underlying financial performance improved from the third quarter of 2018 to the same quarter in 2019, as evidenced by the 14% year-over-year increase in the company's non-GAAP operating earnings.** Berkshire Hathaway's GAAP net income attributable to Berkshire shareholders dropped year-over-year *not* due to weakness in its underlying businesses, but due to reduced net gains from its investment portfolio.

*Berkshire Hathaway...*continued on next page

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

Christopher Araos
Associate Stock and Dividend Analyst
info@valuentum.com

Callum Turcan
Associate Investment Analyst, Co-Editor of Valuentum's Newsletters
info@valuentum.com

Matthew Warren
Independent Financials Contributor & Stock and Economic Strategist
info@valuentum.com

**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.

*Berkshire Hathaway*...from previous page

Under GAAP rules, companies are required to report both the after-tax realized and unrealized gains/losses of equity security holdings on a quarterly basis as investment income/losses. That can often distort the appearance of a company like Berkshire Hathaway's quarterly performance.

| Berkshire Hathaway (In Millions of USD) | | |
|---|---|---|
| Period | Q3 2018 | Q3 2019 |
| Operating Earnings (Non-GAAP) | $ 6,880 | $ 7,858 |
| Net Income Attributable to Berkshire Shareholders (GAAP) | $ 18,540 | $ 16,524 |

***Image Shown:*** *Berkshire Hathaway's underlying non-GAAP operating earnings rose year-over-year in the third quarter of 2019, however, lower net investment gains reduced its GAAP net income attributable to Berkshire shareholders during this period.* ***Image Source:*** *Berkshire Hathaway – 10-Q filing and earnings press release for the third quarter of 2019, table created by the author.*

**Berkshire Hathaway's free cash flow profile remained stellar during the first nine months of 2019.** During this period, the company on a consolidated basis generated $26.6 billion in net operating cash flow and spent $11.1 billion on capital expenditures, allowing for $15.5 billion in free cash flows. Management, namely CEO Warren Buffett and Vice Chairman Charlie Munger, have long been against having Berkshire Hathaway pay out common dividends. That being said, the company did somewhat recently change its stance towards share buybacks to allow for more leeway when it comes to the timing and scale of potential repurchases. **During the first nine months of 2019, Berkshire Hathaway spent $2.8 billion repurchasing its shares, up from $0.9 billion in the same period last year.**

As depicted in the two tables down below, Berkshire Hathaway's strength was widespread in the third quarter of 2019. Non-GAAP operating income growth by segment came from the company's insurance-related investment income (different from investment gains on a consolidated basis), industrial holdings, and other businesses portfolio. Operating income relating to its insurance underwriting segment was broadly flat year-over-year in the third quarter.

| Berkshire Hathaway (In Millions of USD) | | |
|---|---|---|
| Period | Q3 2018 | Q3 2019 |
| Insurance-Underwriting | $ 441 | $ 440 |
| Insurance-Investment Income | $ 1,239 | $ 1,484 |
| Railroad, Utilities and Energy | $ 2,484 | $ 2,644 |
| Other Businesses | $ 2,411 | $ 2,455 |
| Other | $ 305 | $ 835 |
| Operating Earnings (Non-GAAP) | $ 6,880 | $ 7,858 |

***Image Shown:*** *Berkshire Hathaway experienced growth across the board during the third quarter of 2019 on a year-over-year basis.* ***Image Source:*** *Berkshire Hathaway – Third quarter 2019 earnings press release, table made by the author.*

| Berkshire Hathaway<br>Percentage Growth Rates (Year-Over-Year) | |
|---|---|
| Period | Q3 2019 |
| Insurance-Underwriting | 0% |
| Insurance-Investment Income | 20% |
| Railroad, Utilities and Energy | 6% |
| Other Businesses | 2% |
| Other | 174% |
| Operating Earnings (Non-GAAP) | 14% |

***Image Shown:*** *We appreciate Berkshire Hathaway's strong industrial growth given headwinds the sector has been facing of late.* ***Image Source:*** *Berkshire Hathaway – Third quarter 2019 earnings press release, table made by the author*

*Berkshire Hathaway*...continued on next page

*Berkshire Hathaway*...from previous page

**Utility Investments**

Going forward, Berkshire Hathaway is making investments in wind farms, including the $0.2 billion Rattlesnake Ridge Wind development in Alberta, Canada (EWC). That project will add 118 MW of electricity generation capacity to the region and will be owned by BHE Canada, a subsidiary of Berkshire Hathaway Energy. UK-based Renewable Energy Systems is developing the wind farm.

Electricity produced from the facility will be sold under long-term power purchase agreements, and a large corporate customer in Canada has already secured the majority of the wind farm's expected output (according to Bloomberg). Additionally, BHE Canada and Renewable Energy Systems are seeking demand for another wind farm endeavor, the proposed 399 MW Forty Mile Wind Farm that would also be located in Alberta.

As certain government subsidies, particularly those provided by the provincial government of Alberta under the Renewable Electricity Program (which was enacted under a previous provincial government that has since been voted out of office, with the current administration seeking to terminate the program), are set to end, the partnership wants to secure long-term power purchase agreements first before moving forward. Many large corporate customers are seeking to sign such agreements to give the appearance that they are more "forward-thinking" and "green" if you will, meaning economics are taking a back seat to public and government relations. **That makes signing long-term agreements without subsidies an easier task.**

Furthermore, the levelized cost of electricity from wind turbines has steadily marched lower over the years according to Lazard Ltd (LAZ), and that trajectory is expected to continue according to the US Energy Information Administration. **Lower levelized cost of electricity as it relates specifically to utility-scale wind farms makes these endeavors vastly more economical.** BHE Canada owns AltaLink, a regulated transmission company that delivers electricity to about 85% of Alberta's populace. Investing in power generation facilities complements Berkshire Hathaway's existing energy assets in the region. Back in December 2014, Berkshire Hathaway acquired 100% of AltaLink L.P.'s equity. Going forward, AltaLink has various projects in the works that aim to keep its system modern and to maintain grid reliability.

**Concluding Thoughts**

We continue to like Berkshire Hathaway as a top holding in our Best Ideas Newsletter portfolio and appreciate the strong underlying performance in the firm's core businesses. The company offers us exposure to one of the best investment minds in history in Warren Buffett, while the conglomerate offers considerable diversification benefits to the Best Ideas Newsletter portfolio from banking to industrials to insurance and beyond.

Berkshire has made some missteps with Kraft Heinz (KHC), for example, but we continue to be huge fans of the prudence at which Berkshire carries out its affairs, particularly in holding a relatively large cash balance at or near the peak of this decade-plus bull market (it held ~$128 billion in cash equivalents at the end of the third quarter). Once the strength of this bull market begins to fade and weakness in equities takes hold, we expect this large cash balance to come in handy.

From owning some of our favorite companies, including railroad Burlington Northern and aerospace supplier Precision Castparts, to its equity hefty stake in Bank of America (BAC), we expect further upside at Berkshire as the market comes to fully valuing its investment portfolio. Volatile investment gains aside, Berkshire Hathaway reported solid results in its third quarter 2019 earnings update.

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

# PayPal Posts a Blowout Quarter

***Image Source**: PayPal Holdings Inc – 2018 Fast Fact Sheet*

Please note a version of this article was emailed out to members on October 24.

*By Callum Turcan*

On October 23, Best Ideas Newsletter portfolio holding PayPal (PYPL) reported a solid third-quarter 2019 performance, with shares of PYPL up modestly since the report. GAAP net revenues were up 19% year-over-year while its GAAP operating margin jumped over 260 basis points during this period (PayPal notes its non-GAAP operating margin climbed by almost 210 basis points year-over-year, hitting 23.4% last quarter). **Total payment volume rose by 25% year-over-year, or 27% when excluding foreign currency headwinds, which was the main driver behind PayPal's strong performance in the third quarter.**

**Financial Update**

**The company bumped its full-year annual revenue growth guidance upwards on the back of stellar total payment volume growth.** Now, PayPal is targeting 15% annual revenue growth on both a GAAP and non-GAAP basis (adjusted for currency movements), up from 14%-15% previously, with its sales expected to hit $17.0-$17.6 billion in 2019. PayPal's 2019 EPS guidance was shifted modestly downwards, but that's largely due to a material reduction in the firm's net unrealized gains assumption offsetting the favorable impact of stronger-than-expected operational performance.

While PayPal is now forecasting GAAP EPS of $2.03-$2.06 in 2019, down from $2.16-$2.22 previously, note that the company now expects to book $0.11 per share in unrealized gains from its strategic investments this year, down from $0.26 previously. This implies an operational guidance raise, which is primarily why shares are rallying. Unrealized gains and losses are less important to the valuation equation than ongoing operational performance.

**PayPal generated $1.1 billion in net operating cash flows last quarter while spending $0.2 billion on capital expenditures, allowing for $0.9 billion in free cash flows.** Management allocated $0.35 billion towards repurchasing just under 3.3 million shares of PayPal's common stock in the third quarter. We continue to like PayPal's free cash flow growth trajectory and see its short- to medium-term headwinds as very manageable given its impressive operational performance of late.

*PayPal Posts…*continued on next page

*PayPal Posts...*from previous page

**PayPal's Shift Away from eBay Continues**

Something we really like about PayPal's third quarter report is the ever declining percentage of its business that's derived through its relationship with eBay Inc (EBAY). PayPal reported that its eBay Marketplace total payment volume declined 3% year-over-year and represented just 8% of PayPal's company-wide total payment volume, down from 11% in the same period a year-ago. Please note that PayPal's total payment volume derived through eBay Marketplaces stood at 9% in the second quarter of 2019, indicating sequential improvement as well.

About a month ago we published a note highlighting why we think PayPal should be able to thrive in a post-eBay world, and its third quarter performance continues to indicate why that's likely to be the case. Here's what we had to say:

> Since separating from eBay back in 2015, shares of both PayPal and eBay have performed quite well, but PYPL has far and away outperformed EBAY. Part of that separation agreement included a five-year operating agreement that involves PayPal still providing services to eBay in return for various concessions on both sides. One of those services involves processing card payments, and that's on top of prominently displaying the PayPal payment option ahead of other payment services (such as credit/debit cards). After the agreement ends in mid-2020, PayPal will no longer provide card processing services to eBay and is unlikely to retain its favorable location on the checkout website.
>
> Fundamentally these types of operating agreements are about ensuring continuity over the medium-term as each party starts going their own way, enabling consistent financial performance on a forward-looking basis post-separation. Here's an excerpt from PayPal's 2018 Annual Report covering the risks posed to its business from its existing business relationship with eBay (emphasis added):
>
>> *"**Our relationship with eBay is governed, in part, by an operating agreement entered into at separation with a term of five years (expiring July 2020).** This operating agreement defines a number of important elements of our commercial relationship with eBay, as well as certain obligations and restrictions that limit PayPal's provision of services to certain competitive platform operators of eBay (as specified in the operating agreement). eBay remains a significant source of our revenues and operating income."*
>
> In January 2018, eBay signed an agreement with global payments company Adyen (ADYYF) that will see Adyen become eBay's primary payment processor sometime next year, keeping in mind there will be a transition period. PayPal will still be an available option, but when operating on a third-party platform that is actively seeking to transition to a new provider, its market share would likely shrink significantly. We expect that to happen. **That clearly poses a risk to PayPal but not an insurmountable one, not by a longshot.**

We continue to believe this will be the case and see a bright future ahead for PayPal. The company added 9.8 million net new active accounts in the third quarter, bringing its total active accounts to 295 million (up 16% year-over-year). PayPal's 'Merchant Services' volume grew by 31% year-over-year on a constant currency basis. **Growth at Venmo, one of PayPal's peer-to-peer payment processing platforms, continues to be stellar. Venmo's total payment volumes grew 64% year-over-year in the third quarter, rising above $27.0 billion.**

**Balance Sheet Strength**

PayPal exited the third quarter of 2019 with a net cash position of $8.3 billion, keeping in mind this includes non-strategic long-term investments that management includes in the cash, cash equivalents, and investments category.

*PayPal Posts...*continued on next page

***PayPal Posts...*from previous page**

PayPal defines these investments as such (from its 2018 Annual Report, emphasis added):

> *"**Short-term investments** include time deposits, government and agency securities and corporate debt securities with original maturities of greater than three months but less than one year when purchased. Government and agency securities and corporate debt securities are classified as available-for-sale and are reported at fair value using the specific identification method. Unrealized gains and losses are excluded from earnings and reported as a component of other comprehensive income (loss), net of related estimated tax provisions or benefits.*
>
> ***Long-term investments** include corporate debt securities, government and agency securities and equity investments with maturities exceeding one year. Corporate debt securities and government and agency securities are classified as available-for-sale and are reported at fair value using the specific identification method. Unrealized gains and losses are excluded from earnings and reported as a component of other comprehensive income (loss), net of related estimated tax provisions or benefits."*

**We love PayPal's net cash balance and investment grade credit ratings, which supports our thesis concerning why the company is a quality capital appreciation opportunity.**

## Concluding Thoughts

We think PayPal should continue to perform very well going forward as secular growth tailwinds combined with strong operational performance (with an eye towards its rising 'Merchant Services' and Venmo total payment volumes) support the company's free cash flow growth trajectory. The company does not pay out a common dividend at this time but could given its pristine balance sheet and quality free cash flow profile. Our fair value estimate for PYPL stands at $125 per share at the time of this writing.

### Valuation Analysis

**Valuation Assumptions**

| In Millions of USD (except for per share items) | 5-year Projections | |
|---|---|---|
| Revenue CAGR % | 11.2% | |
| Avg. EBIT Margin % | 25.3% | |
| Avg. Cash Tax Rate % | 15.0% | |
| Earnings Before Interest CAGR % | 10.4% | |
| Earnings Per Share CAGR % | 25.1% | |
| Free Cash Flow to the Firm CAGR % | 27.4% | |
| Earnings before interest = Net operating profits less adjusted taxes | Long-term Projections | |
| Phase II --> III FCFF CAGR % | 5.9% (II) | 3% (III) |
| Cost of Equity % | 9.2% | |
| After-tax Cost of Debt % | 4.4% | |
| Discount Rate (WACC) % | 9.1% | |
| Synthetic credit spread = 0.875% | Results | |
| Phase I Present Value | 23,773 | |
| Phase II Present Value | 65,127 | |
| Phase III Present Value | 54,254 | |
| Total Firm Value | 143,154 | |
| Net Balance Sheet Impact | 7,111 | |
| Total Equity Value | 150,265 | |
| Diluted Shares Outstanding | 1,203.0 | |
| Fair Value per Share | $125.00 | |

**Valuation Breakdown**

In the chart below, we show the build up to our estimate of total enterprise value for PayPal and the break down to the firm's total equity value, which we estimate to be about 150.26USD billion. The present value of the enterprise free cash flows generated during each phase of our model and the net balance sheet impact is displayed. We divide total equity value by diluted shares outstanding to arrive at our $125 per share fair value estimate.

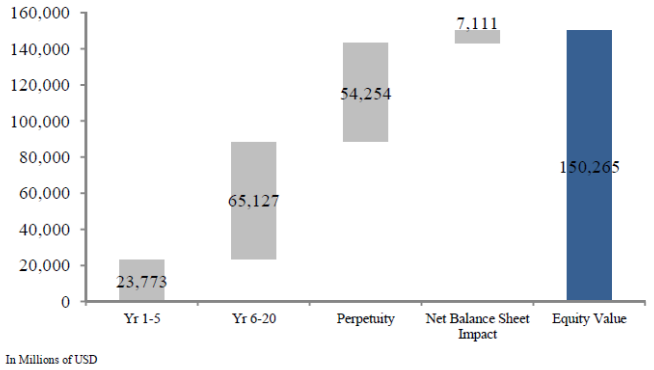



***Image Shown:** An overview of the base case scenario assumptions we used in our discounted free cash flow model to arrive at a Fair Value Estimate of $125 per share of PYPL.*

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

# Asset Light, Free-Cash-Flow Generating Powerhouse Bookings Holding (Priceline) Remains One of Our Favorite Ideas

***Image Source:*** *Booking Holdings Inc – Q3 2019 Press Release*

*By Brian Nelson, CFA*

Booking Holdings (BKNG), formerly Priceline, has been an idea for consideration in the Best Ideas Newsletter portfolio for some time. A number of our best ideas have a few things in common. For starters, they are asset light, meaning that they generally don't require lots of reinvested capital to keep their businesses growing. A byproduct of this feature is that they generate considerable free cash flow, and by extension, they have strong cash-rich balance sheets. Booking Holdings fits the bill, and the company has been a strong performer the past few years, as the chart above shows.

For those that may not be familiar with Booking Holding, the company generates revenue generally from commissions and advertising on well-known websites including Booking.com, KAYAK, Priceline, Agoda, Rentalcars.com, and OpenTable. A substantial portion of its revenue is generated by Booking.com, and the vast majority of its revenue is generated internationally. The company strives to provide consumers with the "best choices and prices at any time, in any place, on any device" for online travel and restaurant and related services.

On November 7, Booking Holdings reported third-quarter results that showed roughly in-line performance on the top line, and a nice beat on the bottom line. During the period, gross travel bookings advanced 7% on a constant-currency basis, helping to drive a similar increase in the top line year-over-year. GAAP operating income advanced 5.5% in the period. Net income advanced 10%, while net income per diluted share of $45.54 leapt 23% thanks to a significant reduction in the share count (43.95 million shares outstanding during the nine months ended September 30 versus 48.53 million in the same period a year ago).

| RECONCILIATION OF CASH PROVIDED BY OPERATING ACTIVITIES TO FREE CASH FLOW | | Nine Months Ended September 30, | |
|---|---|---|---|
| | | 2019 | 2018 |
| | Net cash provided by operating activities | $ 3,788 | $ 4,254 |
| (I) | Additions to property and equipment | (281) | (356) |
| | Free cash flow | $ 3,507 | $ 3,898 |
| | *Free cash flow as a % of Non-GAAP Total Revenues* | *29.9%* | *34.5%* |

***Image Source:*** *Booking Holdings - 3Q 2019 Press Release*

*Asset Light...*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 November 14, 2019**

| Portfolio Holdings | Symbol | Div Yield % | Fair Value | Economic Castle | VBI Rating | P/FV | Last Close | % of Portfolio |
|---|---|---|---|---|---|---|---|---|
| Berkshire Hathaway | BRK-B | 0.00% | $229.00 | NA | 5 | 0.96 | 219.36 | 7%-12% |
| Facebook | FB | 0.00% | $234.00 | Very Attractive | 3 | 0.83 | 193.15 | 7%-12% |
| Alphabet - Class C | GOOG | 0.00% | $1440.00 | Very Attractive | 4 | 0.91 | 1311.46 | 7%-12% |
| Visa | V | 0.67% | $182.00 | Attractive | 6 | 0.99 | 179.75 | 7%-12% |
| Apple Corp. | AAPL | 1.16% | $222.00 | Highest Rated | 6 | 1.18 | 262.64 | 7%-12% |
| SPDR S&P Dividend ETF | SDY | 2.41% | NA | NA | UR | NMF | 105.63 | 5.5%-7% |
| Health Care ETF | XLV | 1.58% | NA | NA | UR | NMF | 95.41 | 5.5%-7% |
| Cisco | CSCO | 2.89% | $56.00 | Very Attractive | 3 | 0.80 | 44.91 | 4%-5.5% |
| Intel | INTC | 2.18% | $51.00 | Attractive | 3 | 1.13 | 57.81 | 4%-5.5% |
| Johnson & Johnson | JNJ | 2.89% | $151.00 | Attractive | 4 | 0.87 | 130.96 | 4%-5.5% |
| Booking Holdings | BKNG | 0.00% | $2158.00 | Highest Rated | 6 | 0.86 | 1865.55 | 2.5%-4% |
| Dollar General | DG | 0.82% | $125.00 | Attractive | 4 | 1.28 | 159.49 | 2.5%-4% |
| General Motors | GM | 4.09% | $48.00 | Attractive | 3 | 0.77 | 36.80 | 2.5%-4% |
| PayPal | PYPL | 0.00% | $125.00 | Attractive | 3 | 0.83 | 103.73 | 2.5%-4% |
| Vanguard REIT ETF | VNQ | 3.09% | NA | NA | UR | NMF | 92.14 | 2.5%-4% |
| **Cash consideration** | - | - | - | - | - | - | - | **10.0%** |

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

***Asset Light…*from page 7**

Though free cash flow faced some pressure in the period, Booking Holdings remains a free-cash-flow generating powerhouse. Free cash flow came in at an impressive ~30% of revenue during the first nine months of 2019, as the company continues to effectively convert revenue growth into free cash flow (capital spending is negligible). At the end of the third quarter, Booking Holdings held $11.76 billion in cash equivalents and long-term investments and $8.5 billion in long-term and convertible debt for a net-cash rich balance sheet.

Our holding in Bookings Holdings in the Best Ideas Newsletter portfolio reflects exposure to the health of the global economy via the strength of travel accommodations. Though aerospace demand (the purchase of airplanes) may be in secular growth mode for some time, we believe air travel demand (the purchase of a plane ticket) remains highly cyclical and exposed to downturns and recessions as well as political and economic uncertainty. Though there may be a time when we remove Booking Holdings on concerns about global economic growth, we're not making this change for the foreseeable future as the firm remains poised for future market share gains. Per its third-quarter conference call:

> *"While we believe these financial results show that we have meaningful size and scale, we note that, against a very large global travel market opportunity, we are still a small share of the marketplace, which means we have substantial opportunity in front of us."*

Looking ahead to the fourth quarter of this year, management expects foreign exchange to negatively impact growth rates across the board (gross bookings, revenue, EBITDA and the like), and for international travel to the United States to feel the impact of a stronger US dollar. Regardless, Bookings Holdings expects gross bookings to grow 2%-4% on a constant-currency basis, and for revenue to advance 1%-3% on a year-over-year basis in the period. Fourth-quarter non-GAAP earnings per share is targeted in the range of $21.50-$22.00, a modest decline "normalizing for constant currency." As is often the case with Booking Holdings' management, we view this guidance as conservative.

**Concluding Thoughts**

***Image Shown**: Booking Holdings' equity has been a strong performer the past few years.*

Booking Holdings fills an important void in our Best Ideas Newsletter portfolio as it provides exposure to the broader global economy, while albeit cyclical, continues to hold up despite myriad threats. Bookings Holdings' asset-light business model translates to tremendous free cash flow generation, and its balance sheet is net-cash rich, two considerations that provide a very strong foundation for our estimate of its intrinsic value, which stands at ~$2,150 (shares are trading at ~$1,860 at the time of this writing). The company does not pay a dividend.

# Intel Still One of Our Favorite Ideas

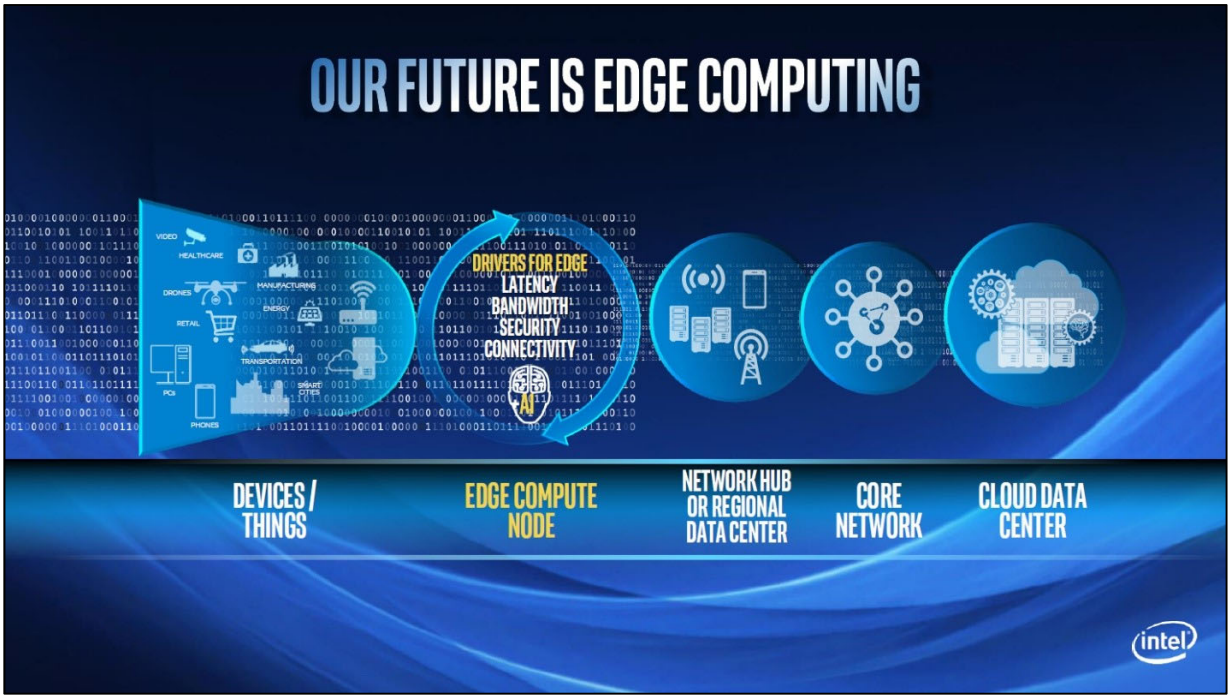



***Image Source:*** *Intel Corporation – August 2019 IR Presentation*

*By Callum Turcan*

A holding in both our Best Ideas Newsletter and Dividend Growth Newsletter portfolios, shares of Intel Corporation (INTC) have been on a strong upward tear since August. We continue to like the company as it appears shares of Intel are converging towards the top end of our fair value estimate range ($61 per share), with INTC trading at roughly $58.50 per share as of this writing. Looking ahead, Intel's solid 2.1x Dividend Cushion ratio provides support for a quality dividend growth story (we rate Intel's Divided Growth trajectory as EXCELLENT), and shares of Intel yield ~2.2% as of this writing.

**Covering the Balance Sheet**

Intel ended the third quarter of its fiscal 2019 (period ended September 28) with $12.0 billion in combined cash, cash equivalents, short-term investments, and trading assets. That's on top of $4.8 billion in equity investments, which now no longer includes semiconductor supplier ASML Holding (ASMLF) as Intel sold off its remaining equity stake in the company (worth $1.1 billion as of December 29, 2018) this fiscal year. Intel continued to own an equity stake in big data software provider Cloudera Inc (CLDR) at the end of its fiscal third quarter. Most of Intel's equity investments are represented by non-marketable equity securities and equity method investments, with only a relatively small amount represented by marketable equity securities at the end of its latest quarter.

Micron Technology Inc (MU) exercised its right to call Intel's interest in IM Flash Technologies back in January 2019, a deal that closed on October 31. As of September 28, that 49% non-controlling interest in IM Flash Technologies represented the vast majority ($1.1 billion) of Intel's equity method investment balance of $1.2 billion. IM Flash Technologies was formed in 2006 by Micron and Intel to develop NAND flash memory and 3D XPoint products. Micron expected to pay Intel $1.5 billion in cash to acquire Intel's stake in the joint venture, which should show up in Intel's fiscal fourth quarter report. The monetization of Intel's non-strategic investments has helped fund its aggressive share buybacks of late.

*Intel Still…*continued on next page

*Intel Still...*from previous page

Additionally, please note that Intel had $3.4 billion in 'other long-term assets' on the books at the end of its fiscal third quarter, which according to Intel's third quarter 10-Q filing for fiscal 2019 are largely represented by corporate debt, financial institution investments (commercial paper, time deposits, etc.), and government debt. **Due to Intel's decision to try to earn a better return on its large cash-like pile, its balance sheet can be a tad less-transparent read than some other companies (but not in a bad way, seeing as Intel has more cash-like holdings than what may be initially perceived).**

**NOTE 10 : FAIR VALUE**

For information about our fair value policies, and methods and assumptions used in estimating the fair value of our financial assets and liabilities, see "Note 2: Accounting Policies" and "Note 16: Fair Value" in our 2018 Form 10-K.

**ASSETS AND LIABILITIES MEASURED AND RECORDED AT FAIR VALUE ON A RECURRING BASIS**

| | September 28, 2019 | | | | December 29, 2018 | | | |
|---|---|---|---|---|---|---|---|---|
| | Fair Value Measured and Recorded at Reporting Date Using | | | | Fair Value Measured and Recorded at Reporting Date Using | | | |
| (In Millions) | Level 1 | Level 2 | Level 3 | Total | Level 1 | Level 2 | Level 3 | Total |
| **Assets** | | | | | | | | |
| Cash equivalents: | | | | | | | | |
| Corporate debt | $ — | $ 329 | $ — | $ 329 | $ — | $ 262 | $ — | $ 262 |
| Financial institution instruments[1] | 1,101 | 460 | — | 1,561 | 550 | 183 | — | 733 |
| Reverse repurchase agreements | — | 1,495 | — | 1,495 | — | 1,850 | — | 1,850 |
| Short-term investments: | | | | | | | | |
| Corporate debt | — | 828 | — | 828 | — | 937 | — | 937 |
| Financial institution instruments[1] | — | 911 | — | 911 | — | 1,423 | — | 1,423 |
| Government debt[2] | — | 110 | — | 110 | — | 428 | — | 428 |
| Trading assets: | | | | | | | | |
| Corporate debt | — | 2,921 | — | 2,921 | — | 2,635 | — | 2,635 |
| Financial institution instruments[1] | 70 | 1,477 | — | 1,547 | 67 | 1,273 | — | 1,340 |
| Government debt[2] | — | 1,773 | — | 1,773 | — | 1,868 | — | 1,868 |
| Other current assets: | | | | | | | | |
| Derivative assets | 62 | 295 | — | 357 | — | 180 | — | 180 |
| Loans receivable[3] | — | 55 | — | 55 | — | 354 | — | 354 |
| Marketable equity securities | 352 | — | — | 352 | 1,440 | — | — | 1,440 |
| Other long-term investments: | | | | | | | | |
| Corporate debt | — | 1,900 | — | 1,900 | — | 1,843 | — | 1,843 |
| Financial institution instruments[1] | — | 890 | — | 890 | — | 912 | — | 912 |
| Government debt[2] | — | 638 | — | 638 | — | 633 | — | 633 |
| Other long-term assets: | | | | | | | | |
| Derivative assets | — | 933 | 23 | 956 | — | 100 | — | 100 |
| Loans receivable[3] | — | 494 | — | 494 | — | 229 | — | 229 |
| **Total assets measured and recorded at fair value** | **$ 1,585** | **$ 15,509** | **$ 23** | **$ 17,117** | **$ 2,057** | **$ 15,110** | **$ —** | **$ 17,167** |
| **Liabilities** | | | | | | | | |
| Other accrued liabilities: | | | | | | | | |
| Derivative liabilities | $ — | $ 440 | $ — | $ 440 | $ — | $ 412 | $ — | $ 412 |
| Other long-term liabilities: | | | | | | | | |
| Derivative liabilities | — | 19 | — | 19 | — | 415 | 68 | 483 |
| **Total liabilities measured and recorded at fair value** | **$ —** | **$ 459** | **$ —** | **$ 459** | **$ —** | **$ 827** | **$ 68** | **$ 895** |

***Image Shown:*** *A breakdown of Intel's balance sheet line items, specifically as it relates to its cash-like assets in the asset section seen at the upper portion of this financial note provided by management.* ***Image Source:*** *Intel – 10-Q Filing, Third Quarter Fiscal 2019*

*Intel Still...*continued on next page

*Intel Still...*from previous page

Intel exited its fiscal third quarter 2019 with $5.2 billion in short-term debt and $23.7 billion in long-term debt on the books. We view Intel's net debt load as very manageable given its sizable free cash flows and hefty cash-like balance.

During the first three quarters of fiscal 2019, Intel generated $11.7 billion in free cash flow (up from $11.2 billion in the same period a year ago) while spending $4.2 billion covering its dividend payments (broadly flat with last year's levels due to share repurchases considering Intel's per share payout grew modestly during this period).

Intel has been aggressively repurchasing shares of late, spending $10.1 billion during the first nine months of fiscal 2019 buying back its stock (up from $8.5 billion in the same period a year ago). For reference, Intel had 4.43 billion weighted-average outstanding shares on a diluted basis during the third quarter of its fiscal 2019, down sharply from 4.65 billion in the same period a year ago.

**Covering Internet of Things Upside**

**By 2022, Intel sees the Internet of Things ('IoT') creating a ~$30 billion total addressable market ('TAM') for its Internet of Things Group ('IOTG') that the semiconductor is very excited about.** In 2018, Intel's IOTG launched its Vision Accelerator Design Products hardware and Distribution of OpenVINO software toolkit to assist its clients in adopting artificial intelligence ('AI') and other applications. While just a small portion of Intel's business right now, the firm's IOTG has grown its revenues from $2.1 billion in fiscal 2014 to $3.5 billion in fiscal 2018. During this period, Intel's IOTG has grown its operating income from $0.6 billion to $1.0 billion, keeping in mind Intel is investing heavily in this segment.

Some of the areas Intel's IOTG is targeting includes retail (using big data analytics gathered from a retailer's customers to enhance that retailer's inventory management and marketing programs), industrial (predictive maintenance is a big opportunity), and construction (creating smart energy management systems). Intel's IOTG offers end-to-end solutions to its clients, leveraging the computing power of Intel's semiconductor offerings to unlock efficiencies and insights in any industry. Here's what Intel's 2018 10-K filing had to say about this segment:

> *"IOTG utilizes adjacent products across Intel while making the investments needed to adapt products to the specific requirements for our vertical segments. We offer end-to-end solutions with our wide spectrum of products, including Intel Atom ® and Intel ® Xeon ® processor-based computing, wireless connectivity, FPGAs, Movidius VPUs, and developer tools such as the OpenVINO™ software toolkit.*
>
> *IOTG product development focuses on addressing the key challenges businesses face when implementing Internet of Things solutions, including interoperability, connectivity, safety, security, industrial use conditions, and long life support. IOTG enables a global ecosystem of industry partners, developers, and innovators to create solutions based on our products that accelerate return on investment and time-to-value for end customers.*
>
> *These Intel ® Internet of Things Market Ready Solutions are vetted and tested in the market, scalable, repeatable, commercially available, and fully supported through our ecosystem partners. These solutions can help streamline operations, automate manual tasks, provide insights from data, and more."*

Going forward, Intel's IOTG plans to continue launching new products that are both scalable and able to address big commercial needs. That could include new offerings that cater towards the transportation, healthcare, and automotive industries.

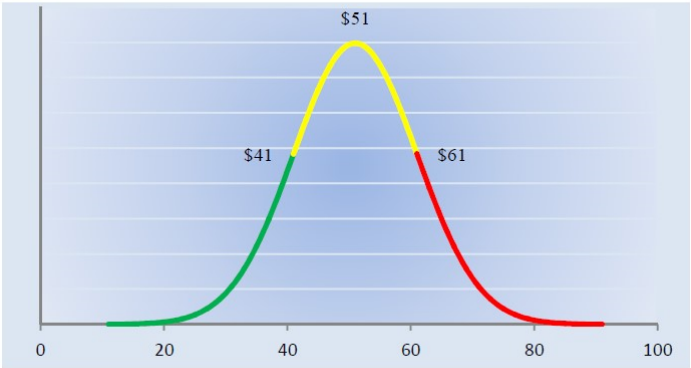
*Intel Still...*continued on next page

***Intel Still...*from previous page**

## Concluding Thoughts

**Margin of Safety Analysis**

**Range of Potential Outcomes**




Our discounted cash flow process values each firm on the basis of the present value of all future free cash flows. Although we estimate the firm's fair value at about $51 per share, every company has a range of probable fair values that's created by the uncertainty of key valuation drivers (like future revenue or earnings, for example). After all, if the future were known with certainty, we wouldn't see much volatility in the markets as stocks would trade precisely at their known fair values. Our ValueRisk™ rating sets the margin of safety or the fair value range we assign to each stock. In the graph above, we show this probable range of fair values for Intel. We think the firm is attractive below $41 per share (the green line), but quite expensive above $61 per share (the red line). The prices that fall along the yellow line, which includes our fair value estimate, represent a reasonable valuation for the firm, in our opinion.

***Image Shown:*** *A visual representation of our fair value estimate range for shares of INTC from our 16-page Stock Report.*

We continue to like Intel in both our newsletter portfolios and see the company's investments in the IoT space (and elsewhere) supporting decent free cash flow growth over the coming years. As Intel continues to monetize portions of its non-strategic equity and debt investments, expect a lot of those proceeds to go towards buying back its stock. That should help see shares of INTC continue converging towards the upper end of our fair value estimate range.

***Image Shown:*** *Shares of Intel appear to be converging towards the high end of our Fair Value Range. We continue to like the company in both our Best Ideas Newsletter and Dividend Growth Newsletter portfolios.*

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

# Procter & Gamble Appears Overvalued

***Image Shown:*** *Shares of Procter & Gamble have been on an epic run since mid-2018, and we think shares have gotten ahead of themselves here.*

*By Callum Turcan*

Consumer staples giant Procter & Gamble (PG) is a solid company that generates sizable and consistent free cash flows. **However, in our view, shares of PG have gotten way ahead of themselves due to a "flight to quality" that has seen the market bid up P&G's share price from the low $70s in April 2018 to approximately $120 as of this writing.** Shares of PG now yield 2.5% as of this writing and trade well above the top end of our fair value estimate range of $101 per share. Please note P&G has paid out a dividend for 129 consecutive years and the company has increased its payout over the past 63 consecutive years, earning it the coveted status of 'Dividend Aristocrat'.

**Quality Cash Flow Profile**

From fiscal 2017 to fiscal 2019 (ended June 30, 2019), P&G generated ~$10.8 billion in annual free cash flows on average. Annual dividend payouts averaged ~$7.3 billion during this period, which were fully covered by free cash flows. **We caution that share repurchases were funded in part by the balance sheet, as stock buybacks averaged $5.7 billion per year on average during this period.** As a consumer staples company, P&G is better positioned than most to weather a slowing global economy as its products will still be in high demand given the significance of hygiene and healthcare offerings in everyone's daily lives.

On October 22, P&G reported first quarter fiscal 2020 earnings (three month period ended September 30). **Its free cash flows came in at $3.1 billion last quarter, easily covering $1.9 billion in dividend payouts but falling short of fully covering $3.0 billion in share repurchases.** We would prefer that the company starts keeping more cash on the balance sheet to pare down its net debt load and enhance its dividend coverage given ongoing geopolitical tensions.

*Proctor & Gamble…*continued on next page

*Proctor & Gamble…*from previous page

### Likely Overvalued

In the graphic below, from our 16-page Stock Report covering P&G, we highlight our forecast assumptions for the company's future financial performance under our base case scenario. **To achieve an intrinsic value well north of $100 per share, an investor would have to believe P&G will grow its top-line consistently at rates well above what we view as reasonable over the medium- and long-term.**

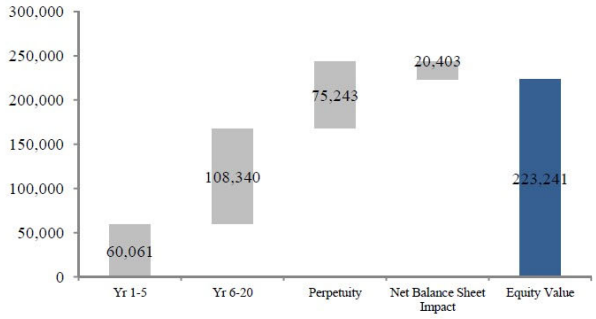
**Valuation Analysis**

**Valuation Assumptions**

| In Millions of USD (except for per share items) | 5-year Projections | |
|---|---|---|
| Revenue CAGR % | 3.2% | |
| Avg. EBIT Margin % | 24.1% | |
| Avg. Cash Tax Rate % | 21.0% | |
| Earnings Before Interest CAGR % | 6.3% | |
| Earnings Per Share CAGR % | 12.8% | |
| Free Cash Flow to the Firm CAGR % | 6.5% | |
| Earnings before interest = Net operating profits less adjusted taxes | Long-term Projections | |
| Phase II --> III FCFF CAGR % | 2% (II) | 3% (III) |
| Cost of Equity % | 9.5% | |
| After-tax Cost of Debt % | 4.8% | |
| Discount Rate (WACC) % | 9.0% | |
| Synthetic credit spread = 1.727% | Results | |
| Phase I Present Value | 60,061 | |
| Phase II Present Value | 108,340 | |
| Phase III Present Value | 75,243 | |
| Total Firm Value | 243,644 | |
| Net Balance Sheet Impact | -20,403 | |
| Total Equity Value | 223,241 | |
| Diluted Shares Outstanding | 2,656.7 | |
| Fair Value per Share | $84.00 | |

**Valuation Breakdown**

In the chart below, we show the build up to our estimate of total enterprise value for Procter & Gamble and the break down to the firm's total equity value, which we estimate to be about 223.24USD billion. The present value of the enterprise free cash flows generated during each phase of our model and the net balance sheet impact is displayed. We divide total equity value by diluted shares outstanding to arrive at our $84 per share fair value estimate.




In Millions of USD

***Image Shown:*** *The "flight to safety" has seen shares of P&G run ahead of themselves, in our view.*

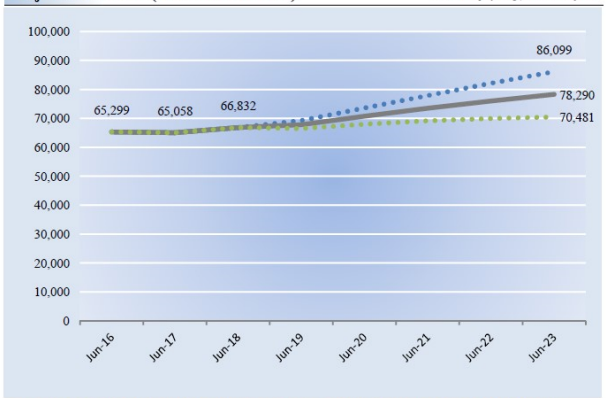
**From 2016-2018, the average revenue growth rate in the industry was below 2% CAGR.** Given the ongoing slowdown in the growth rate of global economic activity (some regions are knocking on the door of a recession), it's unlikely P&G would be able to maintain a revenue CAGR well north of ~3-4% over the coming years in our view. While we expect companies active in the consumer staples sector (particularly large US-based companies with significant overseas sales that have been contending with a strong US dollar for some time now) to see their top-line growth pick up a bit going forward, we see industry revenue growth rates largely matching global GDP growth over the coming years as you can see in the graphic below.

**Revenue Growth** — **MODEST**

| | | Last Fiscal Year Revenue | 3-year Historical CAGR | 5-year Projected CAGR |
|---|---|---|---|---|
| **Procter & Gamble** | USD | **66,832** | **-4.3%** | **3.2%** |
| Clorox | USD | 6,124 | 2.7% | 3.5% |
| Colgate-Palmolive | USD | 15,544 | -1.0% | 2.7% |
| Johnson & Johnson | USD | 81,581 | 5.2% | 2.7% |
| Kimberly-Clark | USD | 18,486 | -0.2% | 1.7% |
| Peer Median | | | 1.3% | 2.7% |
| Industry Median | | | 1.9% | 3.0% |

Procter & Gamble's revenue expansion has trailed the median of both its peer group and its industry group during the past three years. We expect the firm's revenue expansion to outpace the median of its peer group and industry group during the next five years. Our growth assessment of each firm is based on the firm's 5-year forward revenue CAGR. Procter & Gamble's future pace of revenue growth is MODEST, in our opinion.

**Projected Revenue (in millions of USD)** Source: Company Filings, Valuentum Projections




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

***Image Shown:*** *The organic growth rates of the revenue streams of large consumer stables companies based in the US generally track global GDP growth rates.*

*Proctor & Gamble…*continued on next page

*Proctor & Gamble*...from previous page

**What We Think**

Here's a concise view of our thoughts as it relates to the strength of P&G's dividend coverage from our two-page Dividend Report:

> *Procter & Gamble retains its coveted name that has been a part of corporate history for the past ~180 years, but it is a shell of its former self. Once boasting a portfolio of ~200 brands, P&G is now more concentrated with just ~65.* ***In our view, the company still has a lot to prove to show that it packs the punch of a Dividend Aristocrat that has raised its dividend in each of the past 60+ years.*** *Free cash flow averaged ~$10.8 billion during the past three fiscal years (2017-2019), ahead of annual run-rate cash dividend obligations (~$7.3 billion), so we have no immediate concerns with the payout. The recent acquisition of Merck KGaA's Consumer Health business suggests more inorganic growth could be in store, especially if organic growth stagnates.*

The ~$4.2 billion purchase of German-based Merck KGaA's consumer health business, which closed in November 2018, added vitamin and supplement brands Seven Seas, Femibion and Neurobion to P&G's portfolio among other additions. That acquisition will help support P&G's growth trajectory as its over-the-counter offerings for certain consumer health needs expands. This expansion also provides for greater scale in the space, potentially leading to modest synergies. Pivoting to the potential weakness in P&G's dividend coverage, from our two-page Dividend Report:

> *One thing is certain: Procter & Gamble is not afraid of change. Innovation remains the lifeblood of its operations, and management feels that it has a better chance of winning with ~65 leading brands across 10 businesses and industry-based sectors instead of ~200. The jury is still out, however, and though we are giving management the benefit of the doubt for now, we are closely monitoring its progress.* ***Despite material revenue declines in recent years, operating cash flow has held up over the past three full fiscal years.***
>
> *P&G has sold a number of long-term, value-creating brands, in our view, and the company may have moved too quickly through the divestment/transformation process.* ***Total debt of $29.5 billion at the end of September 2019, modestly offset by $9.3 billion in cash and cash equivalents, weighs on its Dividend Cushion ratio. That being said, P&G's Dividend Cushion ratio currently stands at 1.7x, earning the firm a GOOD Dividend Safety rating.***

**Concluding Thoughts**

Procter & Gamble is a great company, but we just can't justify its share price at current levels. While its first quarter fiscal 2020 performance was impressive with an eye towards revenue and margin expansion, **exogenous headwinds will make it hard for P&G to keep living up to the market's lofty expectations going forward.** We are not considering adding P&G to our newsletter portfolios at this time.

***Image Shown:*** *Proctor & Gamble's potential headwinds that are not included in its current guidance.* ***Image Source:*** *Proctor & Gamble – First Quarter Fisal 2020 Earnings Presentation*

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

# Amazon Contends with Rising Operating Expenses and Shrinking Gross Margins

*By Callum Turcan*

Amazon (AMZN) reported third quarter 2019 earnings on Thursday October 24 that underwhelmed investor expectations. While GAAP revenues climbed 24% year-over-year to $70.0 billion in the third quarter, GAAP operating income declined 15% year-over-year to $3.2 billion due in part to rising operating expenses (growth in marketing, technology and content, and G&A expenses outpaced revenue growth) and declining gross margins. Amazon's GAAP gross margin fell by ~70 basis points year-over-year during the third quarter as tariffs began to take their toll, with an eye towards the US-China trade war. **Effectively, Amazon isn't passing along (all of the) cost inflation to its customers in a bid to preserve its dominance in the US e-commerce market and elsewhere.**

**Quarterly Overview**

In North America, Amazon's net sales grew 24% year-over-year in the third quarter, but expenses grew at a faster rate, driving its operating income from this geographical segment lower 37% year-over-year, to $1.3 billion. On the international front, Amazon's net sales grew by 18% year-over-year and its operating loss stayed broadly flat at $0.4 billion (operating income of negative $0.4 billion). AWS, Amazon Web Services, continued to perform well with net sales up 35% year-over-year allowing for its operating income from this segment to shift higher by 9% to $2.3 billion.

**It's very important to note that rising operating expenses at AWS (up 46% year-over-year) combined with growing competitive threats from other cloud computing providers (putting pressure on Amazon's pricing abilities) led to Amazon's cloud segment, its main source of operating income, to underwhelm in the third quarter in terms of profitability.** The company is making big investments in the future of cloud computing to support AWS' promising growth trajectory, but that will in effect cause Amazon's income generation to miss market expectations at times. During the firm's quarterly conference call with investors, Amazon's CFO Brian Olsavsky noted that:

> *"…our margins expectations are that we will price competitively and continue to pass along pricing reductions to customers both in the form of absolute price reductions and also in the form of new products that will in effect cannibalize the old ones. And we also see a point out that you know increasingly what we're doing is renegotiating or negotiating incremental price decreases for customers who then commit to us long term. And if you look at our disclosure on our 10-Q, it shows that we have $27 billion in future commitments for AWS, from AWS customers and that's up 54% year-over-year. So that's another thing to watch, it's not only the short-term commitment, but also the long-term commitment that we see."*

Rising AWS operating expenses during the third quarter came from increases in marketing budgets and major infrastructure investments in anticipation of rising usage from both existing and new customers. Management mentioned that this trend would continue into the fourth quarter, indicating that rising operating expenses will likely consume a good chunk of Amazon's incremental AWS operating profit going forward (at least in the short-term).

**Concluding Thoughts**

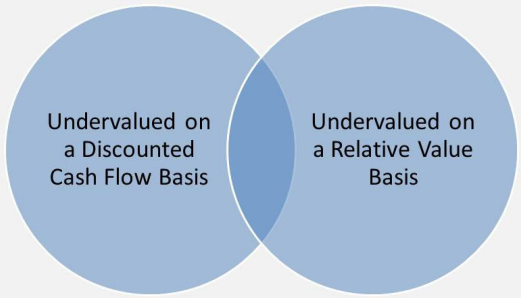
We don't include Amazon in our Best Ideas Newsletter portfolio due in part to its high levels of operating leverage. Small changes in one's valuation assumptions generally cause large swings in the intrinsic value estimates of a company like Amazon. We like Amazon's long-term free cash flow generating potential, and our fair value estimate stands at $2,000 per share, but we are still staying away from the company for now. Amazon would have to be heavily discounted relative to the low end of our fair value estimate range (which stands at $1,500 per share as of this writing) before we could get interested in the name as a potential newsletter portfolio addition.

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

# 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 |
| Lear Corp | LEA | Auto Parts Suppliers | UNDERVALUED | ATTRACTIVE | 0.67 |
| Mosaic | MOS | Chemicals - agriculture | UNDERVALUED | ATTRACTIVE | 0.77 |
| Owens-Illinois | OI | Containers & Packaging | UNDERVALUED | ATTRACTIVE | 0.67 |
| Fluor | FLR | E&C | UNDERVALUED | ATTRACTIVE | 0.65 |
| 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 |
| Capri Holdings | CPRI | Luxury - Ultra & Aspirational | UNDERVALUED | ATTRACTIVE | 0.65 |
| Tapestry | TPR | Luxury - Ultra & Aspirational | UNDERVALUED | ATTRACTIVE | 0.63 |
| Hillenbrand | HI | Personal Services | UNDERVALUED | ATTRACTIVE | 0.79 |
| 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.

---

| Company Name | Symbol | Sector | Industry | VBI |
|---|---|---|---|---|
| AmerisourceBergen | ABC | Health Care | Healthcare Products | 9 |
| Capri Holdings | CPRI | Consumer Discretionary | Luxury - Ultra & Aspirational | 9 |
| Tapestry | TPR | Consumer Discretionary | Luxury - Ultra & Aspirational | 9 |
| Discover Financial | DFS | Financials | Banks & Money Centers | 8 |
| Owens-Illinois | OI | Materials | Containers & Packaging | 8 |

| Company Name | Symbol | Sector | Industry | VBI |
|---|---|---|---|---|
| HEICO | HEI | Industrials | A&D Suppliers | 1 |
| Coca-Cola | KO | Consumer Staples | Beverages - nonalcoholic | 1 |
| Hershey Foods | HSY | Consumer Staples | Food Products - Large | 1 |
| Mondelez Intl | MDLZ | Consumer Staples | Food Products - Large | 1 |
| Nestle | NSRGY | 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 |
| McDonald's | MCD | Consumer Discretionary | Restaurants - Fast Food & Coffee | 1 |
| Yum! Brands | YUM | Consumer Discretionary | Restaurants - Fast Food & Coffee | 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 |
| Graco | GGG | Industrials | Machinery & Tools | 2 |
| Synopsys | SNPS | Information Technology | Semi Equipment | 2 |
| VeriSign | VRSN | Information Technology | Software - security | 2 |
| South Jersey | SJI | Energy | Utilities | 2 |

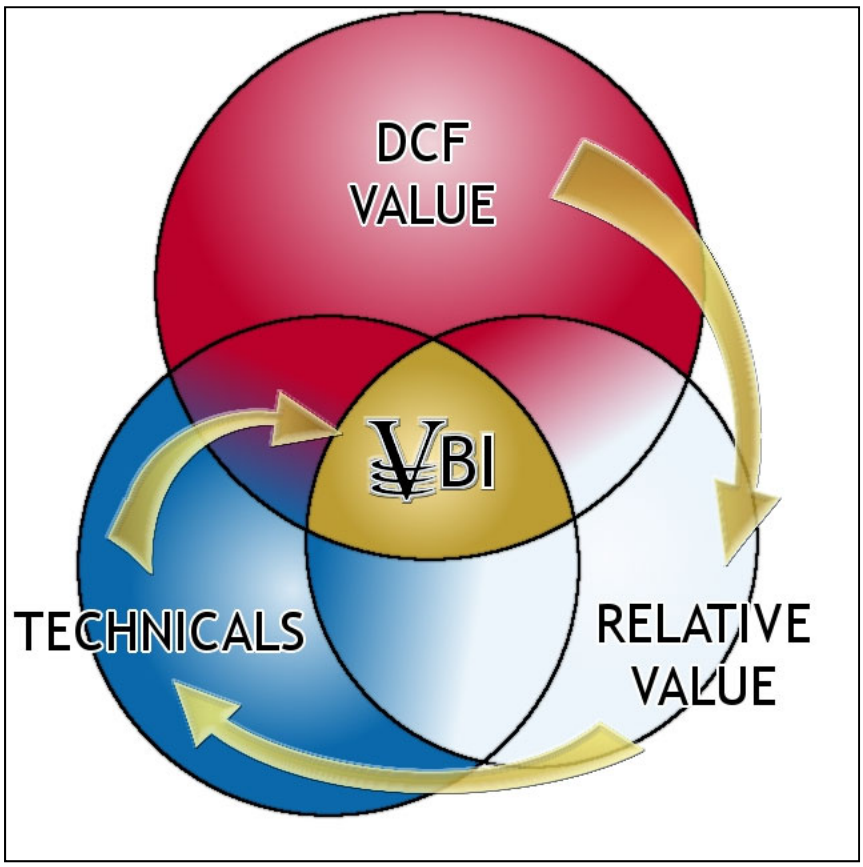
*Ideas...*continued on next page

# 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.

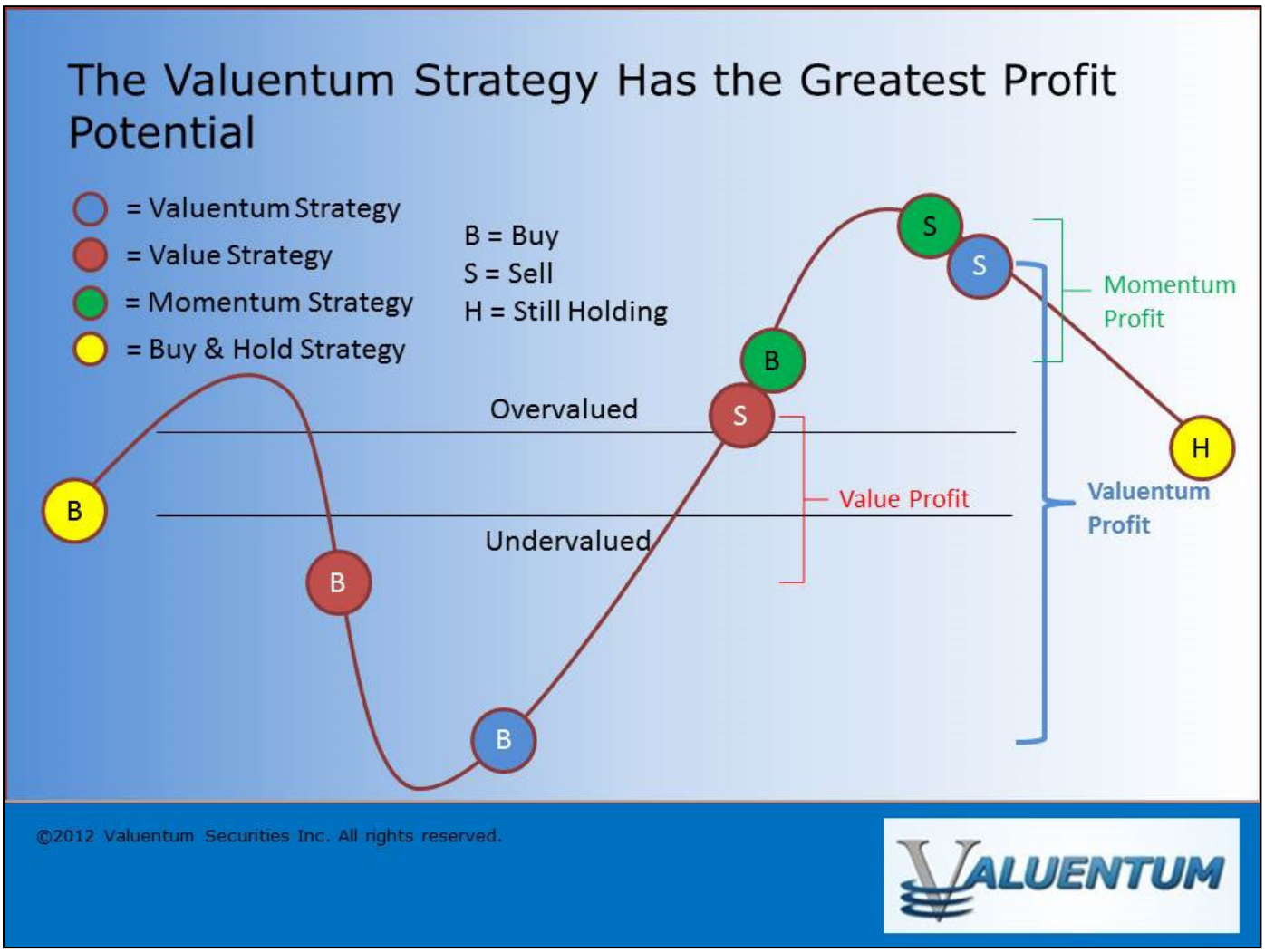



**Illustration for educational purposes only.**

*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.

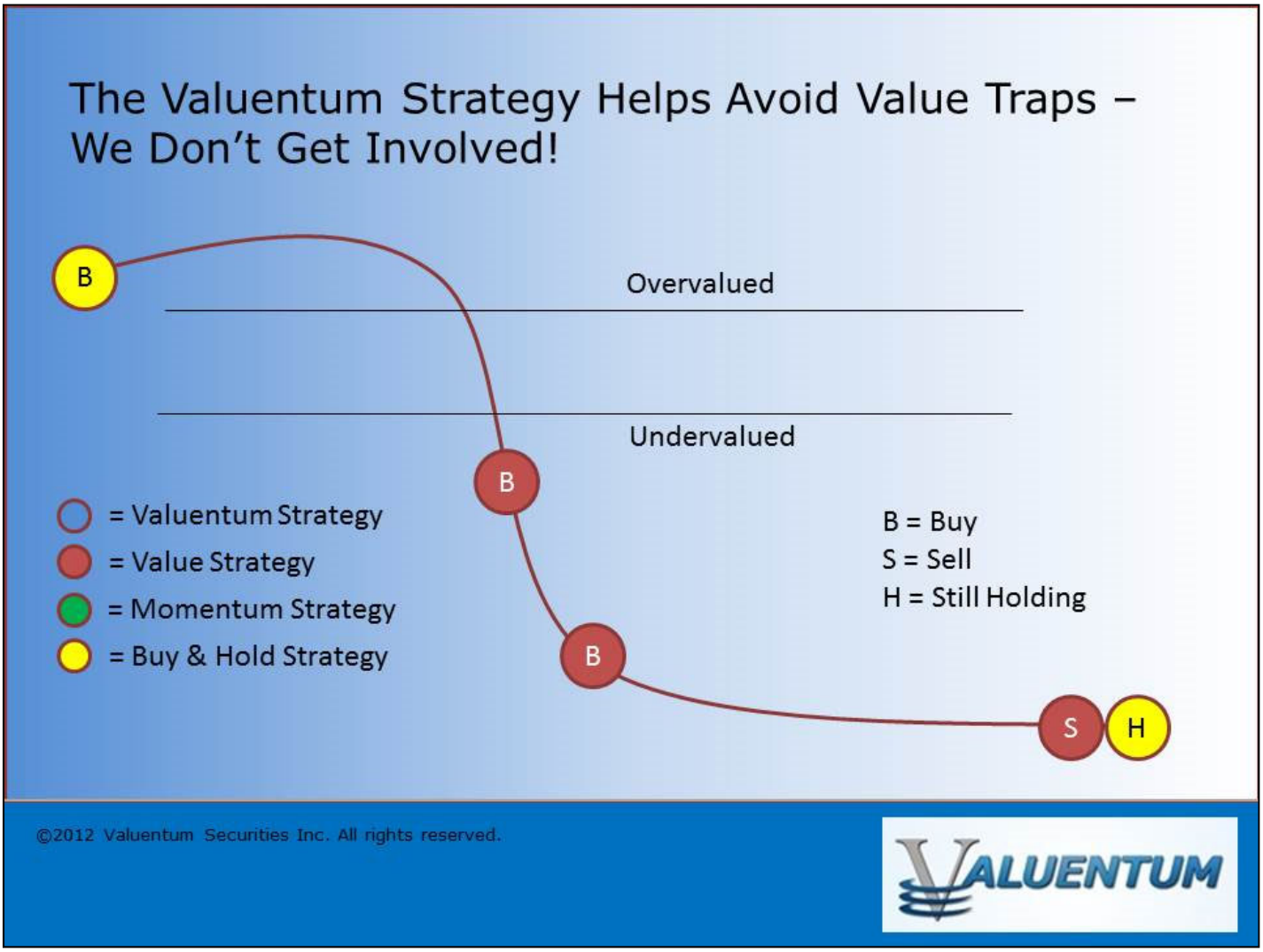



**Illustration for educational purposes only.**

*Our Methodology – The Valuentum Buying Index* continued on next page

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

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

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

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

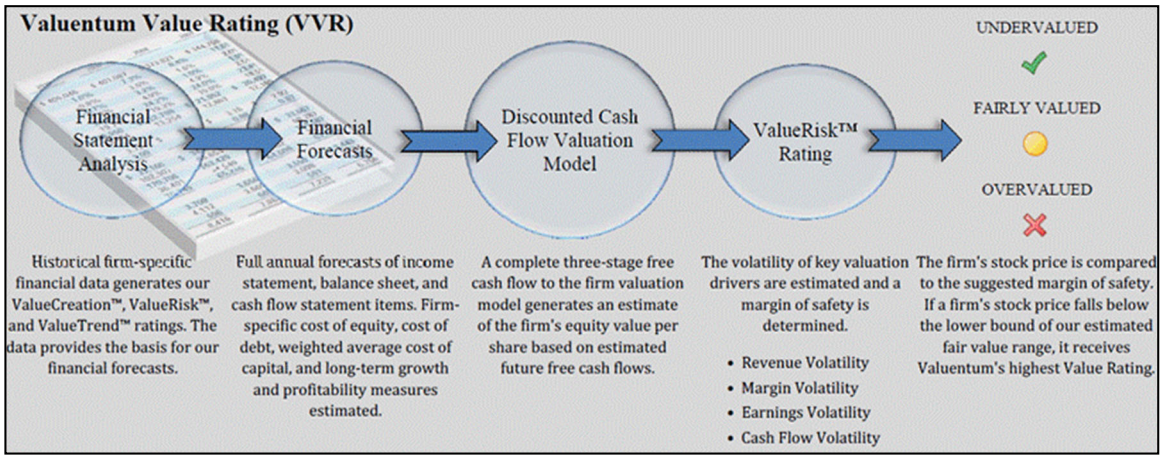



**Illustration for educational purposes only.**

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

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

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

*Our Methodology – The Valuentum Buying Index* continued on next page

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

**Illustration for educational purposes only.**

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

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

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

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

*Our Methodology – The Valuentum Buying Index* continued on next page

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

valuation criteria).

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

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

## Putting It All Together - the Valuentum Buying Index

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

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

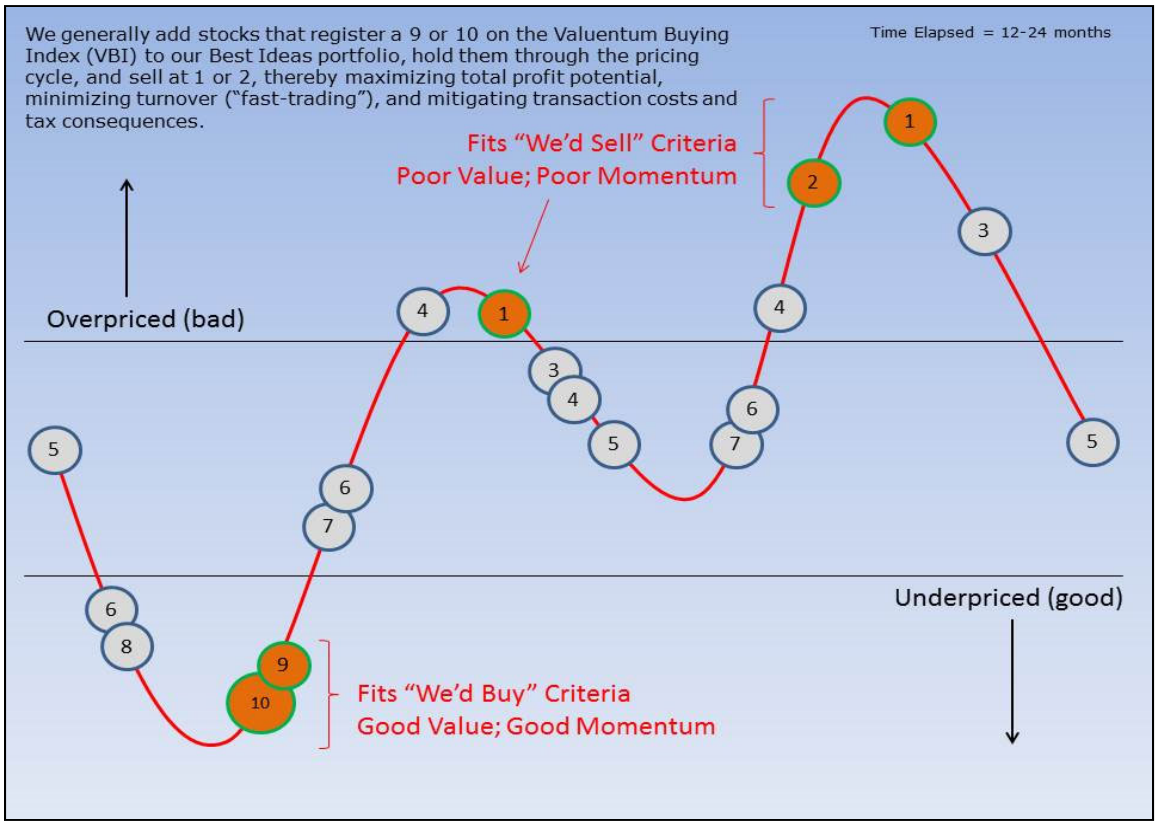



**Illustration for educational purposes only.**

*Our Methodology – The Valuentum Buying Index* continued on next page

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

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

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

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

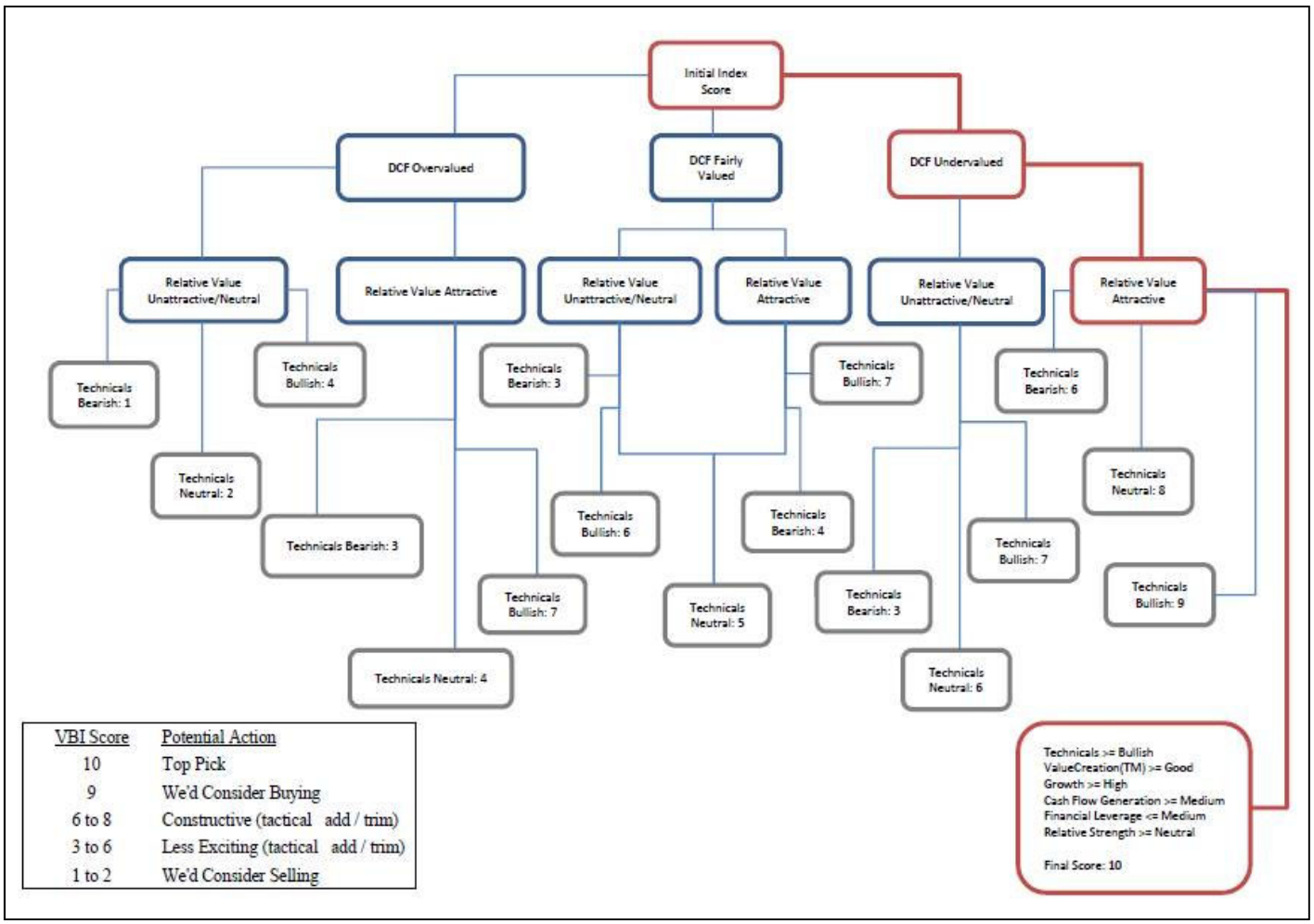



**Illustration for educational purposes only.**

*Our Methodology – The Valuentum Buying Index* continued on next page

# About the Fair Value Range

*By Valuentum Analysts*

## *Understanding the Fair Value Range and Why It's Important*

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

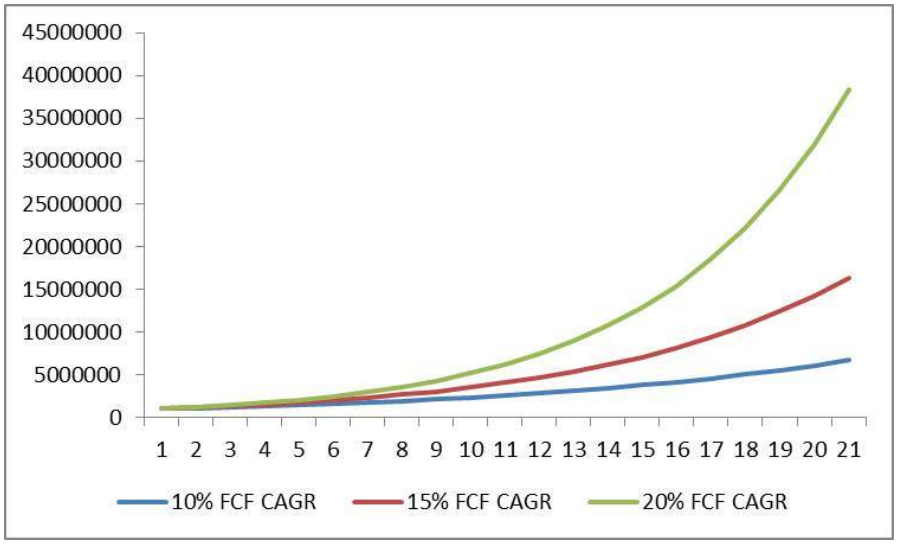
One of the most important concepts of the Valuentum methodology (and valuation in general) is the understanding that the value of a company is a range of probable valuation outcomes, not a single point estimate. Even well-seasoned stock analysts are guilty of saying that a company's shares are worth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

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

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

But why the large range in many cases?

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




*About the Fair Value Range* continued on next page

*About the Fair Value Range* continued from previous page

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

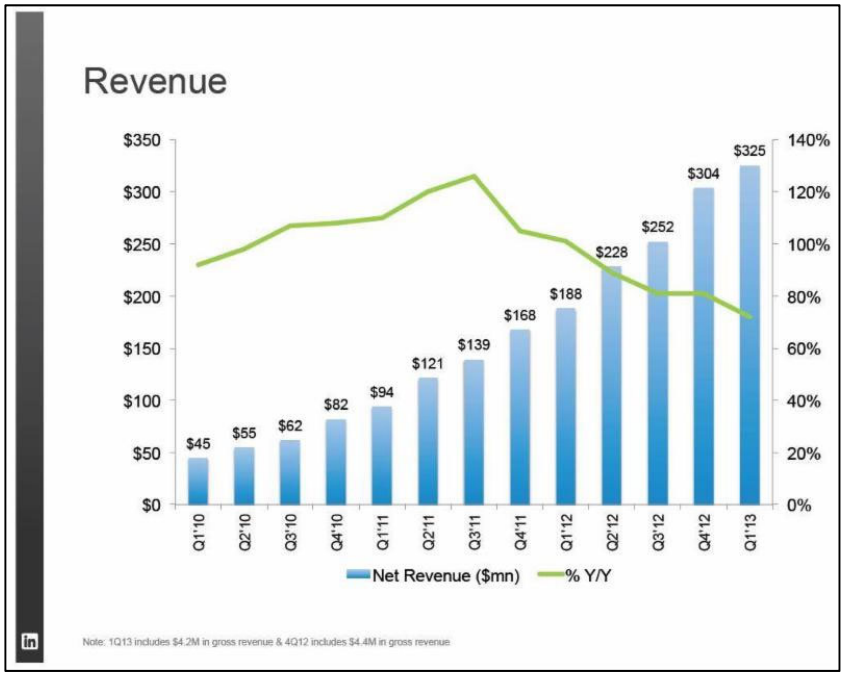



Image Source: LinkedIn

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

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

Shares collapsed in a huge way.

*About the Fair Value Range* continued on next page

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

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

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

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

*By Valuentum Analysts*

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

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

**The Valuentum Buying Index Has Checks and Balances**

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

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

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

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

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

*How We Use* continued from previous page

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

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

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

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

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

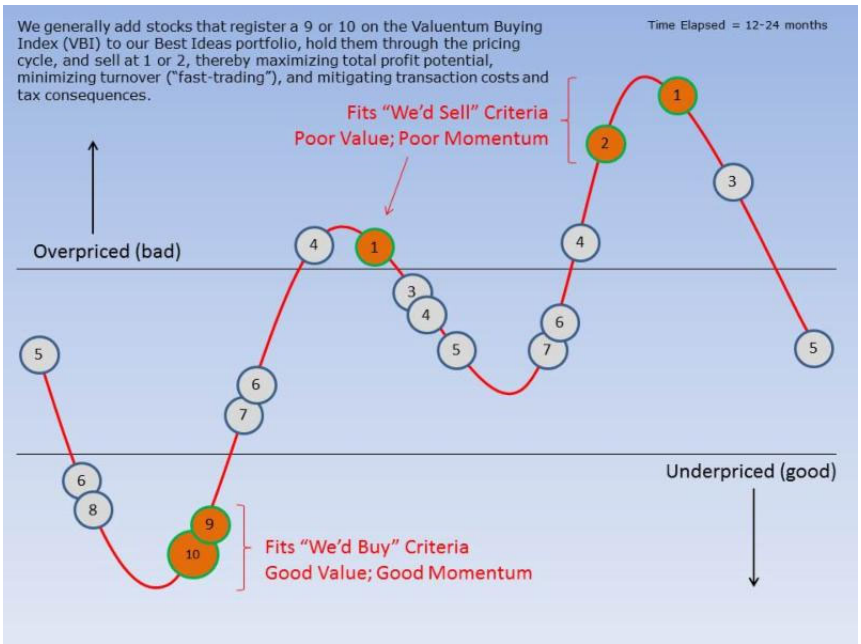



Image shown for informational/illustration purposes only. Valuentum is an investment research publishing company.

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

*How We Use* continued from previous page

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

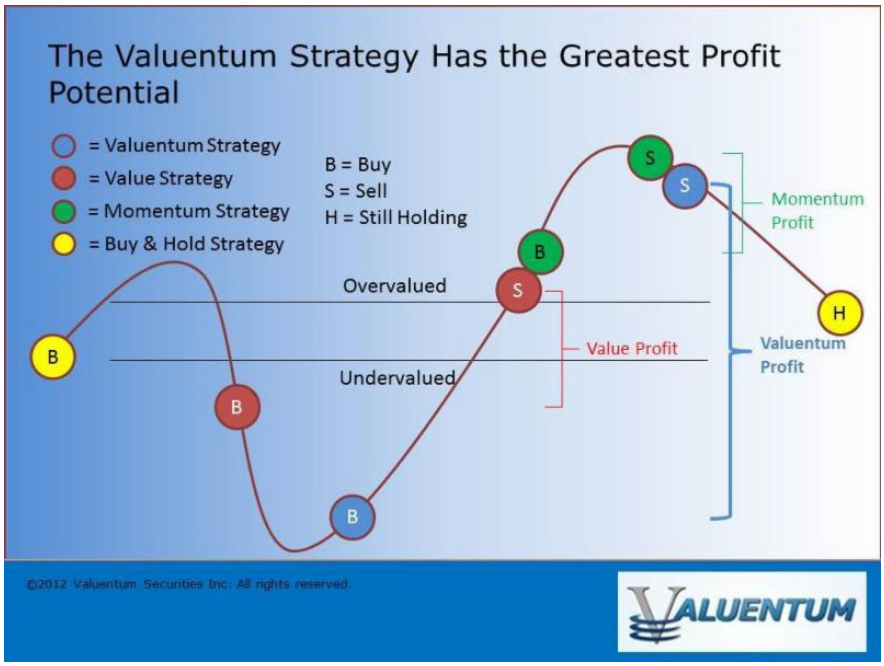



Image shown for informational/illustration purposes only. Valuentum is an investment research publishing company.

**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

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

***How We Use*** **continued from previous page**

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

**Some Examples of the Valuentum Buying Index In Action**

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

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

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

** 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 11

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

Copyright ©2019 by Valuentum, Inc. All rights reserved.

No part of this publication may be reproduced in any form or by any means.

The information contained in this report is not represented or warranted to be accurate, correct, complete, or timely. This report is for informational purposes only and should not be considered a solicitation to buy or sell any security. No warranty or guarantee may be created or extended by sales or promotional materials, whether by email or in any other format. The securities or strategies mentioned herein may not be suitable for all types of investors. The information contained in this report does not constitute any advice, especially on the tax consequences of making any particular investment decision. This material is not intended for any specific type of investor and does not take into account an investor's particular investment objectives, financial situation or needs. This report is not intended as a recommendation of the security highlighted or any particular investment strategy. Before acting on any information found in this report, readers should consider whether such an investment is suitable for their particular circumstances, perform their own due-diligence, and if necessary, seek professional advice.

The sources of the data used in this report are believed by Valuentum to be reliable, but the data's accuracy, completeness or interpretation cannot be guaranteed. Assumptions, opinions, and estimates are based on our judgment as of the date of the report and are subject to change without notice. Valuentum is not responsible for any errors or omissions or for results obtained from the use of this report and accepts no liability for how readers may choose to utilize the content. In no event shall Valuentum be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs) in connection with any use of the information contained in this document. Investors should consider this report as only a single factor in making their investment decision.

Valuentum is not a money manager, is not a registered investment advisor, and does not offer brokerage or investment banking services. Valuentum has not received any compensation from the company or companies highlighted in this report. Valuentum, its employees, independent contractors and affiliates may have long, short or derivative positions in the securities mentioned herein. Information and data in Valuentum's valuation models and analysis may not capture all subjective, qualitative influences such as changes in management, business and political trends, or legal and regulatory developments. Redistribution is prohibited without written permission. Readers should be aware that information in this work may have changed between when this work was written or created and when it is read. There is risk of substantial loss associated with investing in financial instruments.

Valuentum's company-specific forecasts used in its discounted cash flow model are rules-based. These rules reflect the experience and opinions of Valuentum's analyst team. Historical data used in our valuation model is provided by Xignite and from other publicly available sources including annual and quarterly regulatory filings. Stock price and volume data is provided by Xignite. No warranty is made regarding the accuracy of any data or any opinions. Valuentum's valuation model is based on sound academic principles, and other forecasts in the model such as inflation and the equity risk premium are based on long-term averages. The Valuentum proprietary automated text-generation system creates text that will vary by company and may often change for the same company upon subsequent updates.

Valuentum uses its own proprietary stock investment style and industry classification systems. Peer companies are selected based on the opinions of the Valuentum analyst team. Research reports and data are updated periodically, though Valuentum assumes no obligation to update its reports, opinions, or data following publication in any form or format. Performance assessment of Valuentum metrics, including the Valuentum Buying Index, is ongoing, and we intend to update investors periodically, though Valuentum assumes no obligation to do so. Not all information is available on all companies. There may be a lag before reports and data are updated for stock splits and stock dividends.

The portfolio in the Valuentum Best Ideas Newsletter is hypothetical and does not represent real money. Past simulated performance, whether backtested or walk-forward or other, is not a guarantee of future results. Actual results may differ from simulated portfolio information being presented in this newsletter. For general information about Valuentum's products and services, please contact us at valuentum@valuentum.com or visit our website at www.valuentum.com.