Legendary Investing Strategies and Wisdom for Bear Markets

Profit from the Knowledge and Stock Selection Methodologies of History's Greatest Investors

John P. Reese
CEO and Founder
Validea.com (www.validea.com)
Validea Capital Management, LLC
T: 860-519-5140
E: johnreese@validea.com

Exclusive AAII Discount to Validea.com

- 25% discount to Validea.com.
- 30-day risk free trial.
- Use link below.

www.validea.com/exoffer

How do you pick stocks?

- Who here has a strategy for stock selection?
- How many of you deviate from that strategy and let your emotion get the best of you?
- How many of you are unsure of what values you should look at (i.e. P/E ratio, EPS Growth or P/B) when evaluating a stock?
- Is your strategy different when we are in a bear market?

The Story Behind Validea.com & Validea Capital Management

- MIT and Artificial Intelligence Research & Harvard Business School
- Sold first technology company and proceeded to invest in stocks
- Took computer and stock knowledge and combined them to found Validea
- Awarded two U.S. patents in area of Automated Stock Analysis

Other Interesting Developments…

- Authored the book "The Market Gurus: Stock Investing Strategies you can use from Wall Street's Best"
- Columnist for Forbes.com and TheStreet.com. Participant in MSN Money's "Strategy Lab"
- Founded a capital management firm – Validea Capital Management, LLC.
- Sub-advisor on two mutual funds (Omega Funds) offered in Canada.

The Market Gurus

- **Who** are the gurus...
- **Why** have they been selected...
- **What** do the winning strategies consist of...

Underperforming is the norm

- 80% of all professionals fail to outperform the market over long periods of time (10 or 15 years).
- Most professionals underperform by 1-2%, while individuals underperfrom by 2-3%
- Most experts are only right with their predictions 20% of the time*

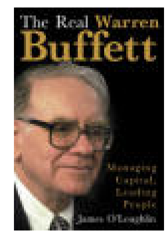
*Source: "Ditch the Experts", Fortune, Feb. 6, 2006

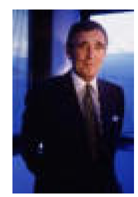
But…

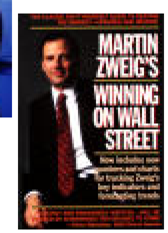
- There are a handful of investors who have proven, either through extensive back testing or real world results, that they can deliver returns that beat the pants off the market.
- What if you knew who these individuals were? Well, we do!

Who: At Validea we follow numerous guru strategies, including:

1. Peter Lynch
2. Ben Graham
3. Warren Buffett
4. Ken Fisher
5. David Dreman
6. Martin Zweig
7. James O'Shaughnessy
8. John Neff
9. William O'Neil
10. Joseph Piotroski







Why: Most Have Long Term Market Outperformance – Real World or Back Tested

Strategy	Performance
Peter Lynch	**29%** p.a. over 13 years (actual)
Warren Buffett	**24%** p.a. over 32 years (actual)
Martin Zweig	**15.9%** p.a. over 15 years (newsletter)
Jim O'Shaughnessy	**22%** p.a. over 40 years (back test)
Joseph Piotroski	**23%** p.a. over 20 years (back test)
David Dreman	**16.6%** over 11 years (actual)
John Neff	**14.3%** p.a. over 24 years (actual)
Joel Greenblatt	**30.8%** p.a. over 17 years (back test)
Ben Graham	**17.0%** p.a. over 30 years (actual)

Returns above are taken from books, back tests or actual money management history of the individuals mentioned in the table.

Why: Each one of these “gurus” has:

- 1) developed a framework to select stocks that has delivered market outperformance
- 2) publicly disclosed these techniques either in books, academic papers or other sources
- 3) created a quantitative methodology that can be leveraged using a computer program

What: Multiple Quantitative Investing Strategies

- Varying Styles - Value, Growth, GARP, Momentum, Small Cap
- Strategies can have anywhere from 5-15 unique criteria
- More than just screens – some of the strategies have aspects of artificial intelligence
- Each strategy selects a different set of securities that score highly based on different measurements

Methodology Example, David Dreman

Key Investing Criteria:

- Look in the universe of the largest cap stocks (1500 largest companies)

Look for a contrarian indication:

- Look for a low price-earnings (PE), price-cash flow (PCF), price-book (PB) and price-dividends (PD) ratios – bottom 20% of market

Earnings and Financial Criteria:

- Look for an increasing earnings trend in past 2 quarters
- Look for EPS growth in the immediate past and projected future to beat market

Dreman Methodology Example Cont…

Look at the financial ratios.

- Strong current ratio (> industry)
- Lower payout ratio than its historical average
- High return on equity (ROE) (top 33%)
- Pretax profit margins (>8%)
- High dividend yield (at least 1% over market)
- Low debt-equity (DE) ratio (<20%)

Do the written strategies of legends still work today?

Yes!

Validea's Model Portfolios Based On Value Strategies - Large Excess Returns over S&P

Portfolio	Based On	Inception Date	Model Ret p.a.	S&P Ret p.a.	Excess Ret. p.a
Value Investor	Benjamin Graham	7/15/03	21.1%	6.4%	14.7%
Contrarian Investor	David Dreman	7/15/03	20.3%	6.4%	13.9%
Book/Market Investor	Joseph Piotroski	2/27/04	11.8%	3.8%	7.8%
Low PE Investor	John Neff	1/2/04	10.1%	4.4%	5.7%

p.a. = per annum

Source: Validea.com – Portfolio Performance (as of 3/3/2008)

Validea's Model Portfolios Based On Growth & GARP Strategies - Large Excess Returns over S&P

Portfolio	Based On	Inception Date	Model Ret p.a.	S&P Ret p.a.	Excess Ret. p.a
P/S Investor	Ken Fisher	7/15/03	23.2%	6.4%	16.8%
Growth Investor	Martin Zweig	7/15/03	20.2%	6.4%	13.8%
P/E Growth	Peter Lynch	7/15/03	17.8%	6.4%	11.4%
G/V Investor	J. O'Shaug-hnessy	7/15/03	17.9%	6.4%	11.5%

p.a. = per annum

Source: Validea.com – Portfolio Performance (as of 3/3/2008)

Exclusive AAII Discount to Validea.com

- 25% discount to Validea.com.
- 30-day risk free trial.
- Use link below.

www.validea.com/exofffer

Why Do They Still Work Today?

- Human emotion prevents many from following these strategies (drawdowns, bubbles and other reasons). Concept of “ever-changing cycles”

- There are certain variables that have proven over time that they show a predictive capability to select outperforming securities on the whole

Why Do They Still Work Today?

- The strategies are not worn out -- Exact strategies are hard to reproduce and replicate
- We use a computer program that is non-emotional and sorts through the entire market of liquid stocks, not just the stock of the day

Why Do They Still Work Today?

- Validea's Guru Strategies seek out fundamentally sound stocks trading at reasonable valuations.
  - French/Fama Study: 1963-1990: Results: high book-to-market stocks outperformed low book-to-market stocks by 2.5x.
  - Takeaway: stocks that are trading at attractive valuations outperform overvalued securities

Source: French/Fama Study
Eugene Fama, Kenneth French

Do they work in a Bear Market?

- Each strategy has proven, either through back test or real world performance, to have great returns over long term (through Bull & Bear Markets)
- Select fundamentally sound stocks: companies need to be profitable - avoided the highly speculative type stocks in late 1990s and Internet boom

Can you blend these strategies together for better risk adjusted performance?

Yes!

Blending these strategies <u>produces better risk adjusted performance</u>

- Value + Growth Strategies = reduces volatility
- Consensus, or blended approaches, hold both value, growth, high dividend and international stocks
- Selects both large and small caps and not tied to specific industry or sectors
- Strategies perform well when varying styles are in and out of favor with investors

Benefit of Blending Value + Growth Strategies

- O'Shaughnessy 40+ year back test
- Highest Sharpe Ratio on United Cornerstone Strategies
  - Large Stocks = Sharpe Ratio of 45
  - Cornerstone Growth = Sharpe Ratio of 63
  - Cornerstone Value = Sharpe Ratio of 64
  - United Strategies = Sharpe Ratio of 68

Source: "What Works on Wall Street", James O'Shaughnessy

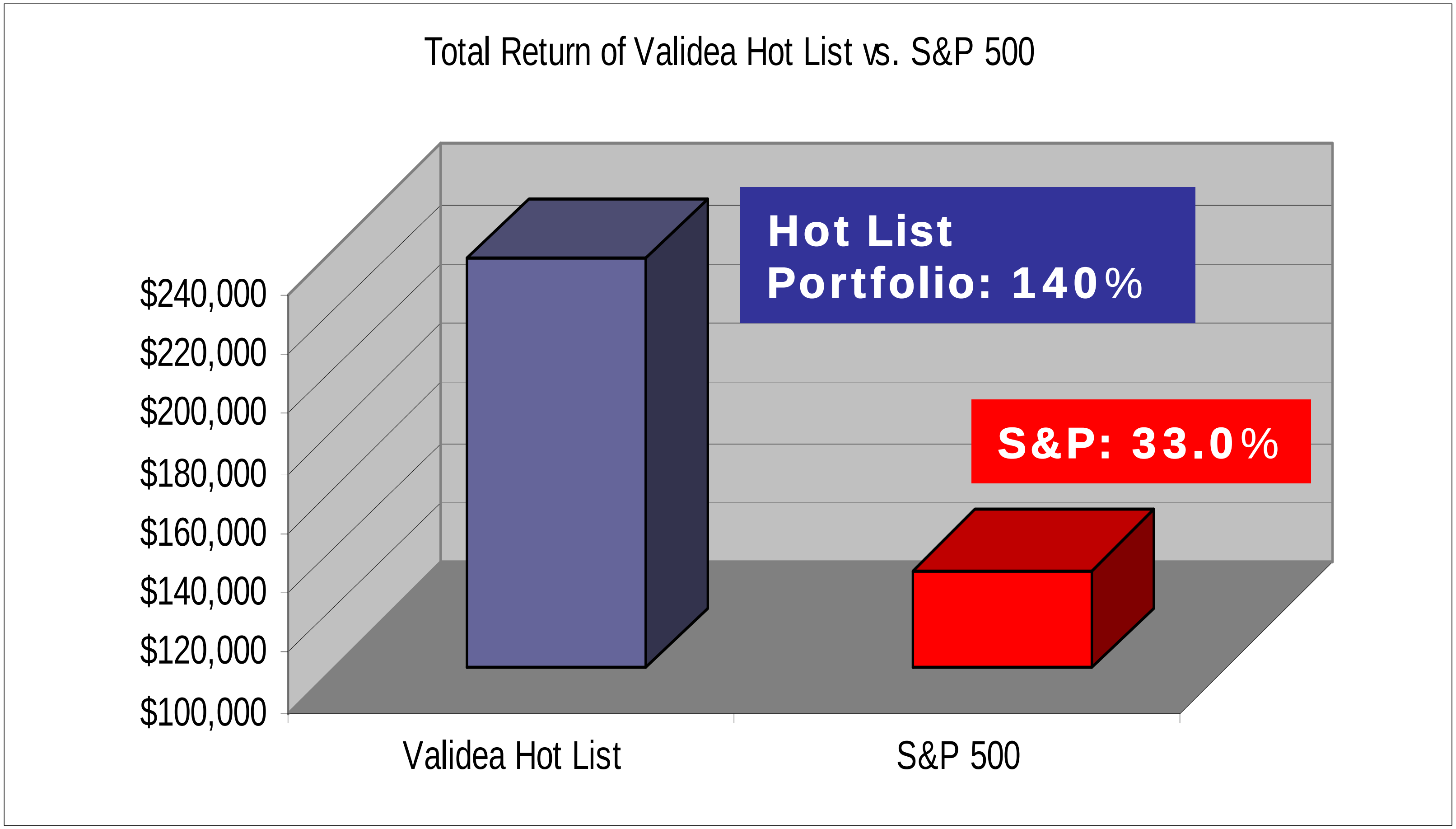
Validea “Consensus” Internal Study

- Combined 14 different quantitative strategies together (equally weighted) and measured performance of the combined portfolio (i.e. consensus approach) vs. standalone strategy portfolios.

- **Result:** Consensus portfolio produced the highest Sharpe ratio (best risk adjusted return) vs. all standalone guru portfolios.

Consensus Portfolio (ALL)	
Total Return	122.98%
Annual Return	19.12%
Sharpe	**1.05**
Sharpe of S&P 500	0.36
Performance data from 7/15/03 – 1/31/08.	

Validea Hot List (Consensus Approach) vs. S&P 500



Source: Validea.com – Portfolio Performance (3/4/08)

Great returns, but how much risk?

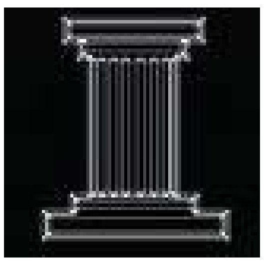
- Sharpe Ratio Formula: (Annualized Return – Risk Free Rate) / Standard Deviation

- Hot List Sharpe Ratio: 0.85
- S&P 500 Sharpe Ratio: 0.17

- Since July 15, 2003 the Hot List has rewarded investors and delivered superior risk adjusted returns.

Other Key Pillars In Strategy

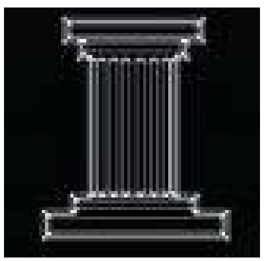
- Monthly Rebalancing (opportunity cost of not selling & best performance)
- You need to stick to strategy for the long term
- Look for opportunities across all market segments
- Remove emotion from the equation
- Hold baskets of 10, 20 or 50 stocks
- Equally weighted portfolio – i.e. with a 20 stock model each holding accounts for 5% of portfolio



Rebalance
Long Term
All Cap
Emotion
Portfolio Construction

Redefining Long Term Investing with Frequent Rebalancing

- Rebalancing (opportunity cost of not selling & best performance).
- Annualized Performance since 7/15/03



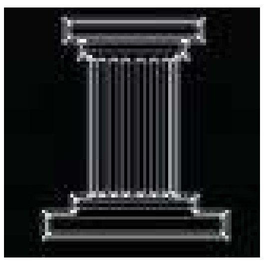
Rebalance
Long Term
All Cap
Emotion
Portfolio Construction

Rebalancing Period	10 Stock Model (avg. p.a)
Annually	10.8%
Quarterly	14.3%
Monthly	16.3%

Source: Validea.com 3/3/08

Model Portfolio Example – Frequent Rebalancing and After Tax Returns

G/V Investor (O'Shaughnessy)	Total Return	Tax Rate	Total Return After Tax
S&P 500	6.4%	15%	**5.4%**
Annual Rebalancing	10.6%	15%	**9.0%**
Monthly Rebalancing	17.9%	35%	**11.6%**

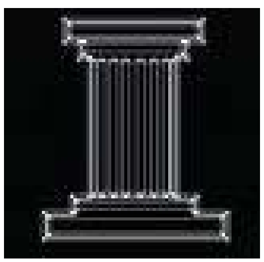


Rebalance
Long Term
All Cap
Emotion
Portfolio Construction

Source: Validea.com – Portfolio Performance (as of 3/3/08)

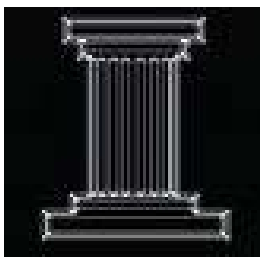
Redefining Long Term Investing

- Don’t have to hold onto stocks for the long term to be a long term investor – goes against conventional wisdom
- Hold onto the strategies for the long term not the stocks
- Buy and Hold strategies, in our testing, fail to produce the best returns



To Be Successful You Need To Stick To The Strategy, Even After Down Years

- Seminal Study by Joel Greenblatt in “The Little Book That Beats the Market”. Greenblattt is the founder of Gotham Capital



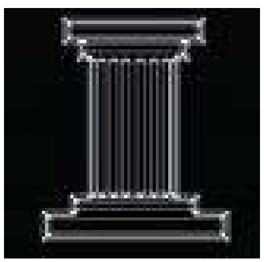
1 Year Period	2 Year Period	3 Year Period
Under-performed 25% of the time	Under-performed 17% of the time	Outperformed 95% of the time

- Rebalance
- **Long Term**
- All Cap
- Emotion
- Portfolio Construction

Source: Joel Greenblatt, “The Little Book That Beats the Market” (John Wiley & Sons, Inc., 2006)

Use Strategies To Find Opportunities Across All Market Segments

- Different styles work over different time periods



Rebalance

Long Term

All Cap

Emotion

Portfolio Construction

Style	Return, 1993-1999	Return, 1993-2002
Small value	13.90%	**15.23%**
Small growth	16.92%	8.20%
Large value	17.72%	10.43%
Large growth	**21.64%**	11.08%
Wilshire 5000	20.47%	11.69%

Source: John Mauldin, “Bull’s Eye Investing” (John Wiley & Sons, Inc., 2004)

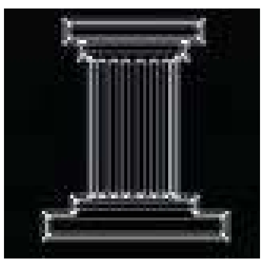
Behavioral Finance:
Removing Emotional Barriers

Biases

Self Deception
- Overoptimism
- Overconfidence
- Self Attribution Bias
- Confirmation Bias
- Hindsight Bias
- Cognitive Dissonance
- Conservative Bias

Heuristic Simplification
- Representativeness
- Framing
- Categorization
- Anchoring
- Availability Bias
- Cue Competition
- Loss Aversion
- Emotion
- Mood
- Self-Control
- Ambiguity Aversion
- Regret Theory

Social Interaction
- Imitation
- Contagion
- Herding
- Cascades



Rebalance
Long Term
All Cap
Emotion
Portfolio Construction

Source: David Hirschleifer, "Investor Psychology and Asset Pricing,", Journal Of Finance 56 (2001), Dresdner, Kleinwort Wasserstein Research

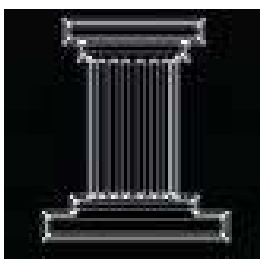
Behavioral Finance: Investor Biases

- **Over Optimism**: We are overoptimistic with our estimate of how we can do and to find good stocks

- **Overconfidence**: Overconfident that your judgment is always right and creates and illusion of control and knowledge.

- **Recency** : Peoples tendency to give too much credence to their most recent, short term experience

- **Loss Aversion**: Fear of losing money and subsequent inability to withstand short term events and maintain a long term perspective



Rebalance

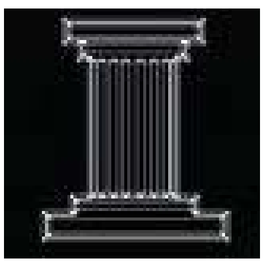
Long Term

All Cap

Emotion

Portfolio Construction

Buffett Quote on Emotions & Discipline



Rebalance
Long Term
All Cap
Emotion
Portfolio Construction

"Investing is not a game where the guy with the 160 IQ beats the guy with the 130 IQ...Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing."

"To invest successfully does not require a stratospheric IQ, unusual business insights, or inside information. What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding the framework."

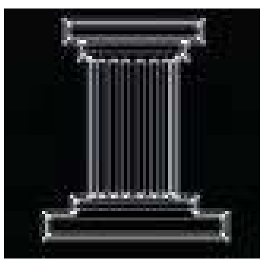
Warren Buffett, Chairman Berkshire Hathaway

Portfolio Construction – equally weighted holdings and diversification

- 10, 20 or 50 Stocks depending on multiple factors like portfolio investment size and risk tolerance

- You can’t beat the market by owning it

- Equally weighted shows optimal historical performance in the Validea system. Studies have shown equal weighting can generate outperformance over market cap weighted approaches.



Rebalance
Long Term
All Cap
Emotion
Portfolio Construction

Exclusive AAII Discount to Validea.com

- 25% discount to Validea.com.
- 30-day risk free trial.
- Use link below.

www.validea.com/exoffer

Key Lessons We have Learned that will help maximize Long Term Performance

- Understand the variables in the strategy. These have proven to be successful and predictive;
- Stick to the strategy through the ups and downs and over the long term;
- Examine and scan entire equity universe. Avoid looking at a few stocks at a time;
- Rebalance periodically (monthly, quarterly or annually) to ensure you are always holding the highest scoring stocks;
- Adhere to the strategy with the utmost discipline and remove emotion.

Bear Markets & The Gurus

"Bear Markets and "GURU" wisdom to think about at times like these…"

Major Index Returns During Latest Market Pullback – it's been tough!

- S&P 500: down -14.5% from 10/5/07 to 1/20/08
- Russell 2000: down -21.0% from 7/15/07 – 1/20/08
- NASDAQ: down -19% from 11/6/07 to 1/22/08

Warren Buffett & Bear Markets

- "Warren is aware that great buys can show up even in a raging bull market, but he has also found that a bear market, where lots of companies are being sold cheap, offers him his greatest opportunity to find a really spectacular deal."

- In the 1987 crash "when all the market went crazy, running off a cliff, Warren was standing at the bottom of that deep abyss waiting for a business he was in love with to drop by." (p.s. this is how he got Coke).

- **Takeaway**: Focus on buying good businesses at reasonable valuations.

David Dreman & Bear Markets

- Contrarian stocks hold up better in bear markets
- During bear markets from 1970-1996, contrarian (i.e. value) stocks outperformed:

Down Markets, 1970-1996,	Avg. Quarterly Return
Low price/dividend stocks:	-3.8%
Low P/E stocks:	-5.7%
Low price/cash flow stocks:	-5.8%
Low price/book value stocks:	-6.2%
Market average:	**-7.5%**
High P/E stocks:	-9.5% (approx.)
Low-yield stocks:	-12.2%

- **Takeaway:** Value stocks can offer up some protection during market declines, but what we should also understand is that each decline is different.

Peter Lynch & Bear Markets

- "They're gonna happen. If you're in the market, you have to know there's going to be declines. … If you're not ready for that, you shouldn't be in the stock market. I mean stomach is the key organ here. It's not the brain. Do you have the stomach for these kind of declines?“

- "What the market's going to do in one or two years, you don't know. Time is on your side in the stock market. … When stocks go down, if you've got the money, you don't worry about it and you're putting more in, you shouldn't worry about it. You should worry what are stocks going to be 10 years from now, 20 years from now, 30 years from now.“

- **Takeaway**: If you are investing in the market you should be investing for the long term (5+ years) and avoiding letting your emotions get the best of you.

James O'Shaughnessy & Bear Markets

- Worst Case Scenarios: All 10% or greater declines for ALL STOCKS (mkt cap at least $150m):
  - Frequency: once every 3.7 years
  - Avg. Decline: -26.4%
  - Decline Duration: 11.7 months
  - Recovery Duration: 10.6 months
  - Shortest Decline: Aug-78 & Jan-80 (2 months)
  - Longest Decline: Feb-00 (31 months)
- **Takeaway:** 10% or greater declines for ALL STOCKS happen once every 4 years, on average, but the good thing is that stocks tend to recover their losses less than a year after the end of a decline.

Final Thoughts and Takeaways

- No one best strategy -- Several strategies are successful long term in the market
- They don’t just work by themselves – scanning 7000 stocks, monthly rebalancing, not cherry picking, blending strategies to improve risk adjusted return
- Based on what these gurus have done, they have returned 15% - 29% average per year
- By following the implemented strategies, you give yourself a very good chance of long term market outperformance
- Short term volatility is one of the reasons the stock market performs so well over the long run and your emotions keep you from maintaining a long term focus.
- A resource, Validea, exists to help you select stocks using those strategies.

Exclusive AAII Discount to Validea.com

- 25% discount to Validea.com.
- 30-day risk free trial.
- Use link below.

www.validea.com/exoffer

Q&A & Contact Info & More…

Questions or Comments:

johnreese@validea.com

info@valideacapital.com

(860) 656-0383

Web Sites of Interest:

www.valideacapital.com

Thank You!