



Stock Strategies for 2020's Historic Market

A presentation on time-tested stock selection methods, narratives influencing markets, investing wisdom, & more –helping you become a better, more educated stock investor in today's unique market environment.

presented by Justin Carboneau
Valida.com

The Big Idea 173 Words

In the first half of 2020, the US stock market had one of the **BEST**, and one of the **WORST**, quarters in history. While this has caused **fear, confusion** and **insecurity** in many investors' minds, it has also created **significant opportunities for active stock investors**.

Ben Graham once said, *"In the short run, the market is a voting machine but in the long run, it is a weighing machine."* As investors seek out new investment ideas, it pays to **move beyond narratives** and learn how to **"weigh" the fundamentals** by following investing rules and methods espoused by investing greats like **Graham, Buffett, Lynch** and others.

Applying their lessons and analyzing firms through **value, growth, and quality** investment measures can **enhance your stock selection process, improve the balance between risk and return in stock picking, and give you a potential edge**.

This presentation, **given exclusively to Fidelity clients**, is dedicated to giving you an overview of the fundamental models inspired by the **time-tested approaches of these legendary investors and learning from their investing wisdom**.

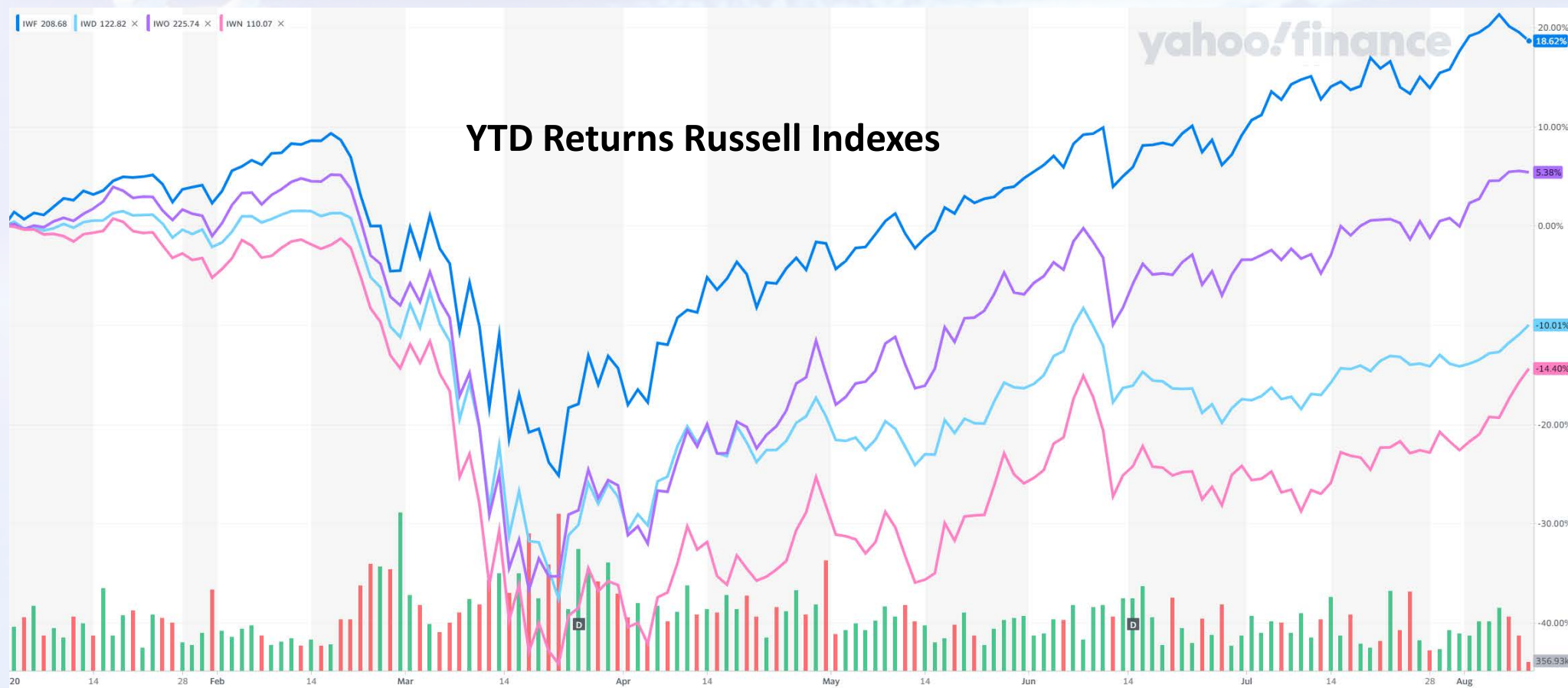
Today's Presentation

- A Look At Trends & Narratives Playing Out In Today's Market
- Who are the Gurus/Strategies?
- What Stock Selection Strategies are Working and Why?
- A Walk Through Detailed Investment Methodologies.
- Channeling the investing of great investors, lessons from Lynch, Buffett and Beyond.
- Learn More
- Q&A

Six Market Trends & Narratives So Far In 2020

1. Growth over Value, Large Over Small
2. Mega Cap Tech Over Everything Else
3. Historic Decline, Historic Recovery
4. Buffett's Cash On Hand
5. Federal Reserve
6. The Retail Traders Are Back

Growth over Value, Large Over Small



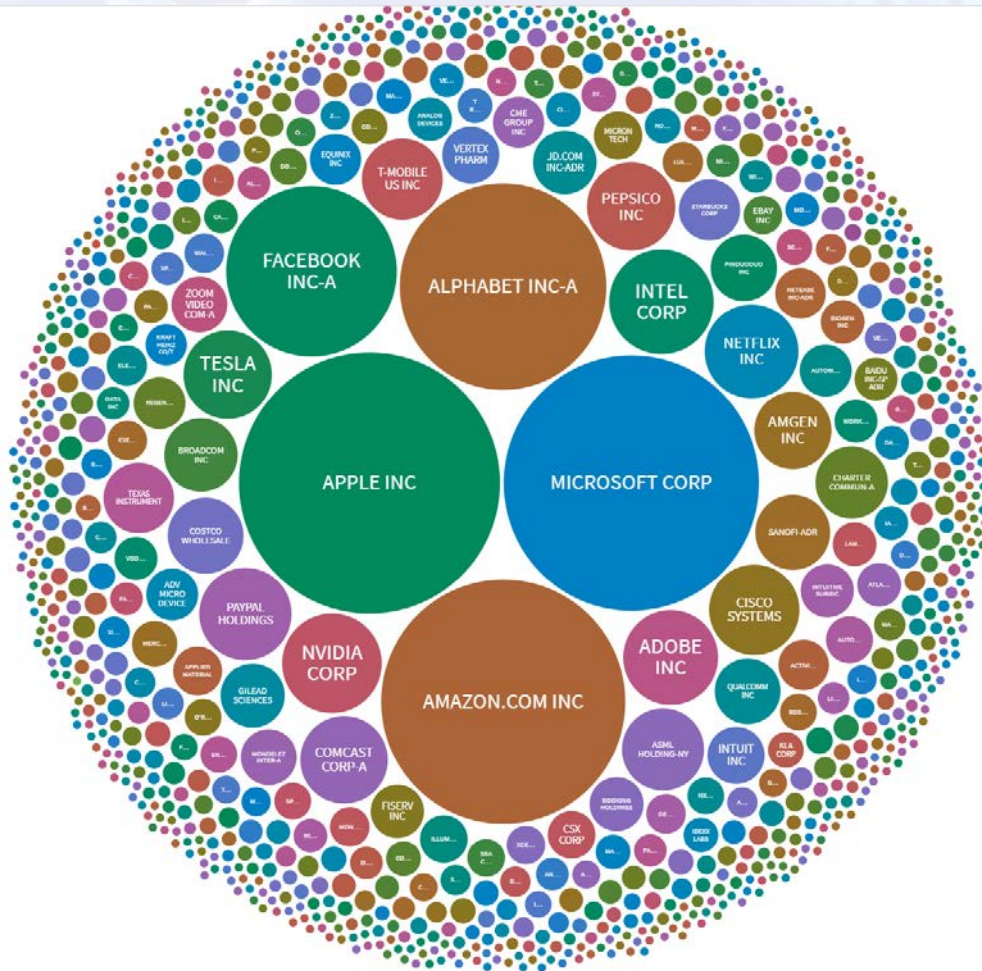
Russell 1000
Growth: 18.6%

Russell 2000
Growth: 5.4%

Russell 1000
Value: -10.0%

Russell 2000
Value: -14.4%

Mega Cap Tech Over Everything Else



<u>Symbol</u>	<u>Company</u>	<u>Weight</u>
AAPL	Apple Inc	11.75%
MSFT	Microsoft Corp	9.50%
AMZN	Amazon.com Inc	9.44%
GOOG / GOOGL	Alphabet Inc	5.71%
FB	Facebook Inc	3.81%
Top Five Nasdaq Composite Holdings		40.2%

Image Source (as of June 25): [Under a Microscope: NASDAQ Composite](#)

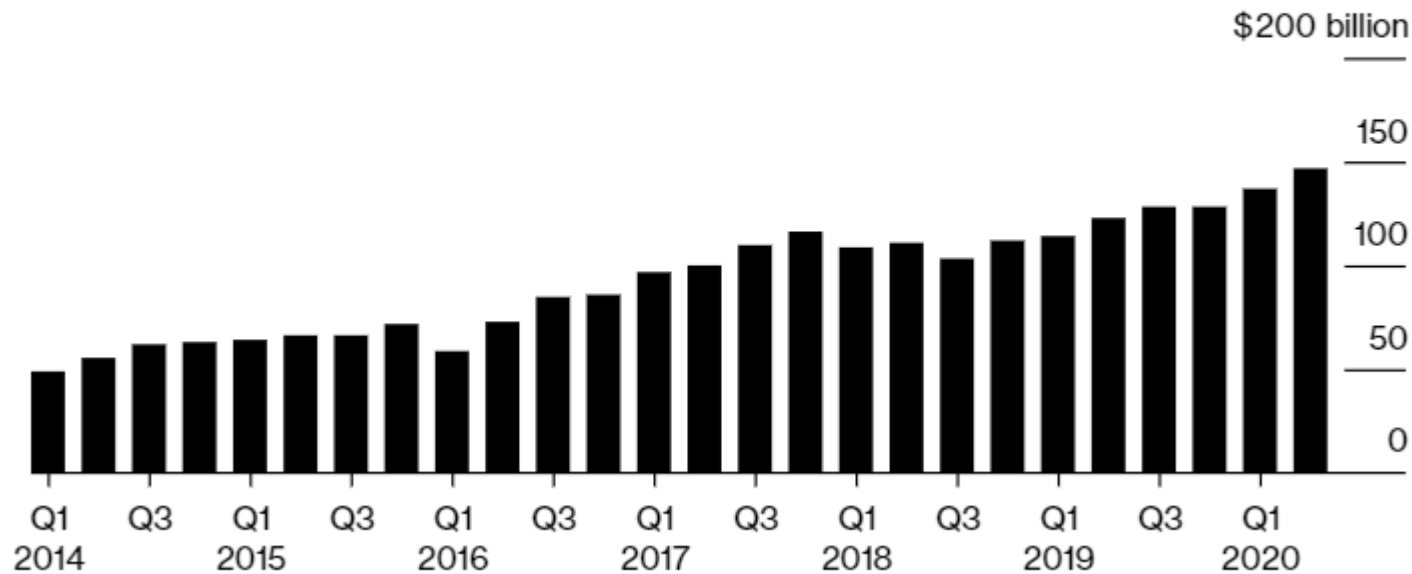
Historic Decline, Historic Recovery

Sector	Average Return (1/1-3/23)	Average Return (3/23-8/10)	# of Companies
Basic Materials	-44.4%	95.3%	167
Capital Goods	-44.6%	102.8%	177
Consumer Cyclical	-46.6%	115.3%	123
Consumer/Non-Cyclical	-28.5%	62.4%	103
Energy	-67.2%	105.2%	124
Financial	-45.3%	54.0%	438
Healthcare	-23.2%	86.9%	484
Services	-43.0%	75.5%	581
Technology	-29.0%	80.3%	505
Transportation	-42.5%	60.6%	87
Utilities	-36.5%	57.9%	82

Buffett's Cash on Hand

Swelling Cash Pile

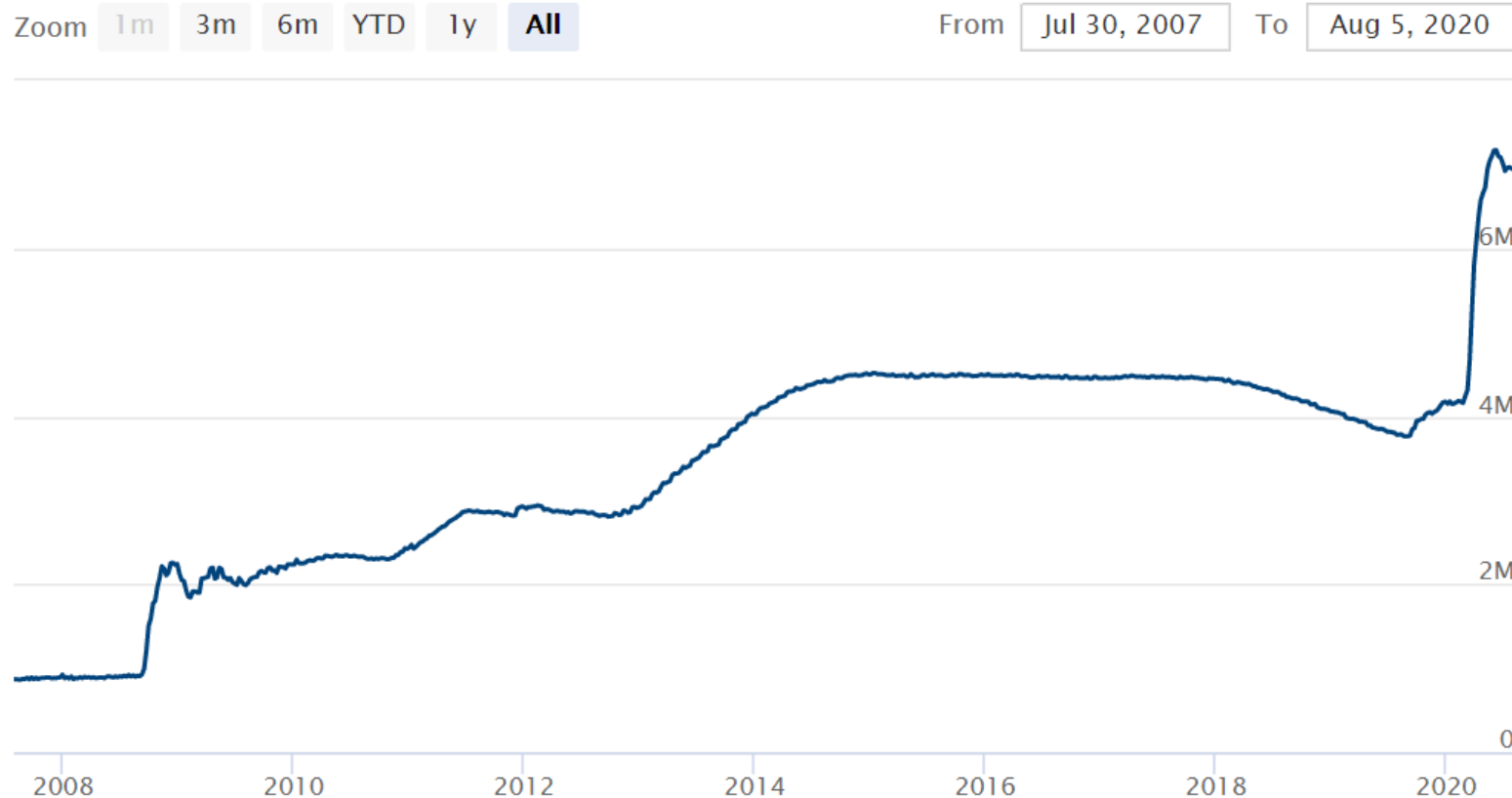
Berkshire's cash hit a new record of \$146.6 billion at the end of June



Source: Company filings

Berkshire's nearly \$147B in cash on hand would make it the 40th largest U.S. company, based on market cap, if the cash traded as a standalone company. Buffett has been mostly quiet, recently putting some money to work buying back his own stock.

Federal Reserve



Federal Reserve's balance sheet has increased from roughly \$1T in 2007 to \$7T today, an increase of 6X in 13 years.

QE1: December 2008 - June 2010
QE2: November 2010 - June 2011
QE3: September 2012 - December 2012
QE4: January 2013 - October 2014
QE 2020 / COVID-19 pandemic: March 2020 - TBD

Chart Source: https://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm

QE Dates Source: [Explaining Quantitative Easing – QE](#)

The Retail Traders Are Back

#	SYMBOL	CHANGE	START	END
1	AAPL	+174,434	524,547	698,981
2	TSLA	+133,608	408,515	542,123
3	MSFT	+126,712	523,875	650,587
4	MRNA	+108,692	210,332	319,024
5	KODK	+87,008	9,405	96,413
6	PFE	+81,475	109,385	190,860
7	AMZN	+81,159	344,791	425,950
8	RKT	+76,211	0	76,211
9	NFLX	+63,997	172,038	236,035
10	AZN	+43,458	31,768	75,226
11	NKLA	+43,410	163,246	206,656
12	INTC	+42,282	62,621	104,903
13	RIGL	+38,231	15,934	54,165
14	IBIO	+33,700	58,054	91,754
15	AMD	+33,653	226,784	260,437

Popular trading app Robinhood added 3 million new accounts in Q1 2020.

Another online brokerage saw more new account openings in March 2020 than in any full year ever on record.

Trading data (see left) shows investors buying the most popular stocks – many are not profitable.

Importance Of Rules & Fundamentals In Stock Selection

"If you're going to invest, you have to follow certain rules. ... The one thing I want everybody who is buying individual stocks to get is that they have to understand the story, the five reasons something is going to go right for the company. If you can't convince an 8-year-old why you own this thing, you probably shouldn't own it. **Don't invest in a company before you look at the financials. If you made it through fifth grade, you can handle the math."**

- Peter Lynch

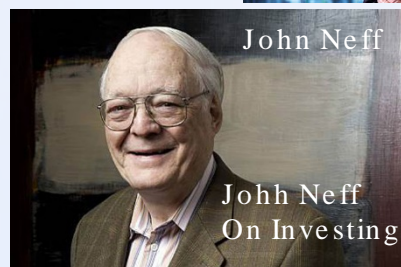
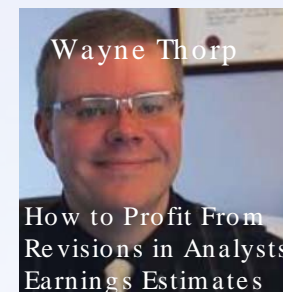
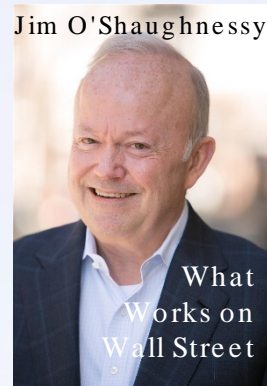
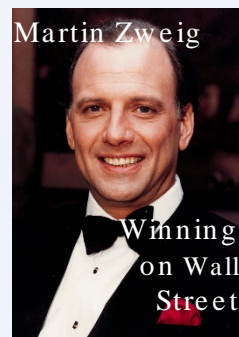
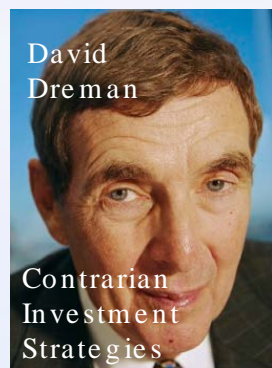
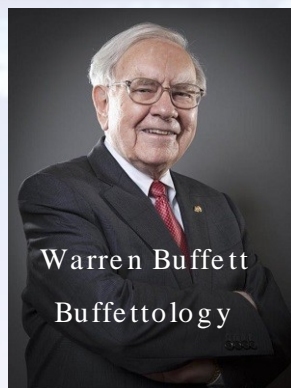
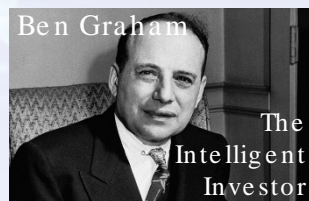
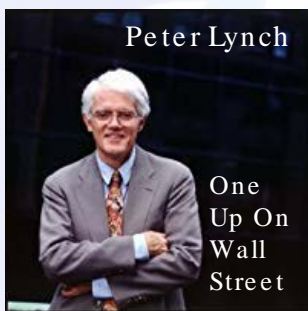
Identifying Successful Investors and Strategies

1. Long term track record of market outperformance, either real-world or back-tested;
2. Publicly disclosed techniques outlined in books, academic papers or other sources;
3. Outlined methodology, largely fundamentally-based, that could be captured and run quantitatively via computer programming and modeling.

Important Note ...

None of the individuals mentioned in today's presentation endorse any of the strategies or our implementation of these strategies. Validea's models are extracted from publicly available sources (a book or research paper by or about each of the individuals mentioned) and are not meant to represent the "gurus" or individuals themselves in any way. All of our strategies are quantitative in nature and the gurus themselves may have changed, altered or never followed these exact strategies. The information presented today is intended to give you an understanding of active and quantitative stock selection strategies only. In addition, individual stock selection can be very risky and none of the material discussed in his presentation should be construed as investment advice or as individual stock recommendations.

Modeling Great Investors & Time-Tested Strategies since '03



pictures are for identification purposes only

Two Ways to Be Used: Stock Analysis & Idea Generation

<u>Individual Stock Analysis</u>	<u>Investment Idea Generation</u>
<ul style="list-style-type: none">- Utilize the fundamental criteria in these strategies and apply to individual stock research.- Hone in on key financials, valuation metrics and technical variables that have been deemed robust and important.- Start to incorporate rules or thresholds in your own process as you familiarize yourself with a strategy.	<ul style="list-style-type: none">- Rather than creating a screen from scratch, you can extract fundamental criteria outlined and tested by these investors.- Screens provide a way to source new investment ideas efficiently and across hundreds or thousands of stocks.- Add in additional different variables to further refine or sort stocks.

The Range of Strategies, from Value to Momentum

names are for identification purposes only

<u>Value</u>	<u>Value Cont ...</u>	<u>Value & Quality</u>	<u>Quality & Yield</u>	<u>Growth / GARP</u>	<u>Momentum</u>
Ben Graham Value Investor	James O'Shaughnessy Value Composite Investor & Growth/Value Investor (CSV)	Warren Buffett Patient Investor	Pim van Vliet Multi-Factor Investor	Peter Lynch PE/G Investor	Wesley Gray Quantitative Momentum Investor
Ken Fisher P/S Investor	Tobias Carlisle Acquirer's Multiple Investor	Joel Greenblatt Earnings Yield Investor	Patrick O'Shaughnessy Millennial Investor	The Motley Fool Small Cap Growth Investor	Dashan Huang Twin Momentum Investor
John Neff Low P/E Investor	Validea Private Equity Investor		Meb Faber Shareholder Yield Investor	James O'Shaughnessy Growth/Value Investor (CSG)	Validea Momentum Investor (CANSLIM)
David Dreman Contrarian Investor				Partha Mohanram P/B Growth Investor	
Joseph Piotroski Book/Market Investor				Wayne Thorp Earnings Revision Investor	

A In-depth Look At 3 Distinct Models

names are for identification purposes only

- **Top Performer YTD**
- **Top Value Performer off of March Low**
- **Biggest Surprise of 2020**

A Detailed Look at Three Models Across Styles
... and the evidence and investment thesis supporting each

Winners In the Growth Stock Category

Strategy, Evidence & Investment Thesis in Today's Market

names are for identification purposes only. Returns for Validea model portfolio are simulated model returns and do not represent actual money management returns..

Fundamental Investing Insight

Within the growth stock universe, which tend to be more expensive stocks, looking at consistency in fundamentals vs. competition and reinvestment in the business are positives.

<u>Strategy</u>	<u>Source/Evidence</u>	<u>Investment Thesis</u>
This growth model looks for low book-to-market stocks that exhibit characteristics, via their fundamentals and the trends in those fundamentals, that associated with sustained future growth .	From 1979 to 2001 to the top scoring stocks is Mohanram's *study generated a simulated return of 20.3% per year vs. 11.3% for S&P 500. Since 2006, P/B Growth Optimal Model Portfolio is up 15.3% per year vs. 6.8% for the market .	Expensive stocks generally underperform the market, but applying a series of fundamental strength and reinvestment criteria can identify outperformers among expensive stocks. Top growth names have been winners in this market environment. Should the trend continue, this model looks poised to continue to benefit .

P/B Growth Investor

based “Separating Winners from Losers...” research paper by Partha Mohanram
names are for identification purposes only.

Growth Stock Filter

How do we filter for the universe of growth-like stocks?

Needs to trade bottom 20% of the market based on the Book/Market ratio (which is the inverse of the Price/Book ratio). Looks for the MOST expensive stocks.

Profitability & Cash Flows

Rewarding both profits and cash flows.

Return on assets (ROA) above the industry average.
Cash Flow from Operations to Assets above industry average.
Cash Flow from Operations to Assets vs. ROA above industry average.

Variability in the Business

How to look at the fundamentals and reward consistency vs. the competition.

Variance of a firm’s return on assets below the industry average
Variance of year-over-year sales growth below the industry average

Investing in the Future

What ways show investment and commitment for future growth?

R&D, CAPEX and Advertising intensity (3 distinct factors) ratios are higher than the industry.

Summation / Final Scoring

By summing all the scores, we can identify the top stocks.

Firms are given a point for each of the criteria above that they pass. Stocks that obtain the highest score are the most favored by the model.

Example: PayPal (PYPL)

for illustration purposes only. not investment advice.

Growth Stock Filter

How do we filter for the universe of growth-like stocks?

Book/Market of 0.08 puts it in the lowest 20% of stocks (so it's in the 20% of the most expensive), indicating a growth-like company.

Profitability & Cash Flows

Rewarding both profits and cash flows.

Return on assets of **4.73% is above industry average**

Cash flow from operations to assets of **5.86% is above industry average**

Cash flow from ops to assets (5.86%) is higher than return on assets (4.73%), a positive.

Variability in the Business

Rank by intermediate momentum to find strongest performing stocks

Variance of return on assets **below industry average.**

Sales variance **below industry average.**

Investing in the Future

What variables show investment and commitment for future growth?

Advertising/assets of **below industry**, cap ex/assets of **above industry** and R&D/assets of **above industry.**

Summation / Final Scoring

PYPL gets 88% based on GSCORE. Also, gets 70%+ from FIVE ADDITIONAL MODELS (BONUS)

Company **passes majority of the criteria** in the model, **obtains a 88% score.**

Replicating Private Equity in Public Markets

Strategy, Evidence & Investment Thesis in Today's Market

names are for identification purposes only. Returns for Validea model portfolio are simulated model returns and do not represent actual money management returns.

Fundamental Investing Insight

Investors can attempt to mirror the returns of Private Equity without the high fees using a portfolio of publicly traded leveraged small-cap value stocks.

Strategy

This strategy looks for stocks that are **inexpensive based on enterprise value to EBITDA** and attempts to **leverage that value exposure** by focusing on firms with **above average debt** that have the demonstrated the ability and **willingness to pay it back**.

Source/Evidence

2015 Study, "Leveraged Small Value Equities". From 1965-2013 the back test in the paper **produced 25.1% annual** return when holding the top 25 stocks.

Investment Thesis

The returns of the **value factor** can be **magnified** by investing in firms that responsibly employ operating leverage in their businesses.

Private Equity Investor

based on a strategy outlined in “Leveraged Small Value Equities”

names are for identification purposes only

Filter for Smaller Firms

Only the smallest companies in the market are eligible to be selected.

The strategy requires a market capitalization to be between the 25th and the 75th percentile of the all stock universe, essentially limiting the universe of stocks to the small cap segment of the market.

Filter for Value Stocks

Look for the Cheapest stocks in the value universe

Enterprise value to EBITDA multiple be in the bottom 25% of the universe.

Levels of Debt

Successful private equity investments tend to use leverage to magnify their returns over time and this model looks for public companies with high degrees of leverage.

Model looks for companies that have an above average debt in relation to their enterprise value.

Four criteria to indicated the ability to pay down debt

Strategy uses four additional criteria to measure a company's ability to repay its debt.

- 1) Change in long-term debt: debt falling over time.
- 2) Long-term debt to assets: percentile rank based on long-term debt to assets.
- 3) Gross profit to assets: percentile rank based on profits to assets.
- 4) Asset turnover: increasing, indicating the assets of the firm are improving the level of sales/revenue.

Example: Interface (TILE)

for illustration purposes only. not investment advice.

Filter for Smaller Firms

Only the smallest companies in the market are eligible to be selected.

\$845.0 million market cap places it in the **50th percentile of our database**, thus passing this criterion.

Filter for Value Stocks

Look for the Cheapest stocks in the value universe

requires EV/EBITDA multiple be in the bottom 25% of the market. **TILE's EV/EBITDA is 5.40**, which places it in the **10th percentile of our database**. Passes.

Levels of Debt

Successful private equity investments tend to use leverage to magnify their returns over time and this model looks for public companies with high degrees of leverage.

TILE's Debt/EV is 0.63, which places it in the 89th percentile of our database (higher percentile = higher debt/EV), therefore it passes this test.

Four criteria to indicated the ability to pay down debt

Strategy uses four additional criteria to measure a company's ability to repay its debt.

TILE long-term debt was \$565M in the most recent FY vs. \$587M in the previous FY (**PASS**)

TILE Debt/Assets is 0.45, which places it in the 85th percentile, (lower is better). (**FAIL**)

TILE Gross Profits/Assets is 0.40, which places it in the 16th percentile of our database (**PASS**)

Emulating Buffett Quantitatively

Strategy, Evidence & Investment Thesis in Today's Market

names are for identification purposes only. Returns for Validea model portfolio are simulated model returns and do not represent actual money management returns.

Fundamental Investing Insight

Looking for consistent earnings, return on equity and return on capital over time can be an excellent quantitative way to identify firms with a competitive moat.

Strategy

This strategy seeks out firms with **long-term, predictable profitability and low debt relative to profits** that trade at reasonable valuations. The model goes back as far as a decade into a company's history to **uncover stocks with competitive moats**.

Source/Evidence

Since 1965 Warren Buffett has compounded at **20.5% for 53 years**.

Buffett-inspired strategy scored Apple 100% in 2015, two years before Buffett. Based on book, *Buffettology*.

Optimal Buffett Model Portfolio up **35.6% in 2019**.

Investment Thesis

Buying **high quality stocks at a discount** can produce a **less volatile way** to access the **outperformance of value stocks**. If you're lucky, maybe find Buffett-like stocks before he actually buys.

Patient Investor

based on method outlined in the book “Buffettology”

names are for identification purposes only

**Consistent, LT
Profits:**

Are earnings predictable?

Looks at 10 years worth of earnings to see if they are consistent, predictable

Long-Term Returns:

Does the firm generate above average returns on equity and capital?

10 years of ROE, ROC or ROA (for Financials). Is there a moat around the business & profitability.

**Earnings Power &
Debt:**

Can the earnings of the firm pay down debt over time?

Favors firms that can pay down their debt with 2-5 years worth of earnings.

**Free Cash
Flow:**

Is free cash flow a positive?

Buffett likes businesses that don't have to spend too much on capital expenditures.

**Share
buybacks:**

Is the company repurchasing shares?

Buying back stock means each existing shareholder is entitled to a higher percentage of the profits generated by the firm.

Retained Earnings:

How has management done in terms generating returns on retained earnings?

Wants to see that retained earnings are being put to use in a productive way and generating returns and profits

Is the Price Right?

Aims for a 12-15% long term return using the combination of two methods the ROE and EPS methods.

Example: Monster Beverage Corp (MNST)

for illustration purposes only. not investment advice.

Consistent, LT Profits:

Are earnings predictable?

Last 10 Years of EPS: \$0.38, \$0.51, \$0.62, \$0.65, \$0.92, \$0.95, \$1.19, \$1.50, \$1.76, \$2.03.
Long term EPS growth rate is **18.6%**, based on the long term EPS growth

Long-Term Returns:

Does the firm generate above average returns on equity and capital?

10 Yrs / 24.5%, 27.3%, 47.8%, 32.8%, 30.7%, 12.0%, 20.2%, 21.7%, 26.5%, 26.1% (**avg. 25%**)
10 Yrs / 24.5%, 27.3%, 47.8%, 32.8%, 30.7%, 12.0%, 20.2%, 21.7%, 26.5%, 26.1% (**avg. 27%**)

Earnings Power & Debt:

Can the earnings of the firm pay down debt over time?

This company has no long-term debt.

Free Cash Flow:

Is free cash flow a positive?

MNST's free cash flow per share of **\$1.85 is positive**, indicating that the company is generating more cash than it is consuming.

Share buybacks:

Is the company repurchasing shares?

Shares outstanding have **fallen over the past five years from 608M to 531M.**

Retained Earnings:

How has management done in terms generating returns on retained earnings?

Management has proven it can earn shareholders a **15.7% return** on the retained earnings

Is the Price Right?

Using the avg. of the two methods used, investors may be able to **expect an avg. return of 18.4%** on MNST stock for the next 10 years.

Lessons From Lynch, Buffett & Beyond ...

Being a long-term optimist | **Buffett** & **Lynch**
Respecting Simplicity & Your Circle of Competence | **Buffett**
Controlling Emotions & Biases | **Lynch** & **Buffett**
Avoid Cutting Your Flowers and Watering Your Weeds | **Lynch**
Disciplined Rationality* | **Buffett**

*Excess Returns Podcast: [A Conversation about Buffett, Berkshire & High-Quality Shareholders w/ Professor Lawrence Cunningham](#)

I Questions...



Disclosures:

The information provided in this communication is solely for educational purposes and should not be construed as advice or an investment recommendation. Fidelity Investments is a separate company, unaffiliated with Validea. There is no form of partnership, agency affiliation, or similar relationship between Validea and Fidelity Investments, nor is such a relationship created or implied by the information herein. Fidelity Investments has not been involved with the preparation of the content supplied by Validea and does not guarantee or assume any responsibility for its accuracy or completeness.

Modeling Successful Investors and Time-Tested Strategies since 2003

names are for identification purposes only

Individual (Guru)	Model Name	Source (book or academic paper)
Warren Buffett	Patient Investor	Buffettology
Ben Graham	Value Investor	The Intelligent Investor
Peter Lynch	P/E/Growth Investor	One Up on Wall Street
Ken Fisher	Price/Sales Investor	Super Stocks
Martin Zweig	Growth Investor	Winning on Wall Street
Joel Greenblatt	Earnings Yield Investor	The Little Book that Beats the Market
James O'Shaughnessy	Growth/Value Investor	What Works on Wall Street (1st Ed)
John Neff	Low P/E Investor	John Neff on Investing
David Dreman	Contrarian Investor	Contrarian Investment Strategies
The Motley Fool	Small Cap Growth Investor	The Motley Fool Investment Guide
Joseph Piotroski	Book/Market Investor	Value Investing: The Use Of Historical Financial Statement Information

Individual (Guru)	Model Name	Source (book or academic paper)
Partha Mohanram	P/B Growth Investor	Separating Winners from Losers among Low Book-to-Market Stocks
Pim van Vilet	Multi-Factor Investor	The Conservative Formula
Wesley Gray	Quant Momentum Investor	Quantitative Momentum
Tobias Carlisle	Acquirer's Multiple Investor	The Acquirer's Multiple
Wayne Thorp	Earnings Revision Investor	How to Profit From Revisions in Analysts' Earnings Estimates
Patrick O'Shaughnessy	Millennial Investor	Millennial Money
Dashan Huang	Twin Momentum Investor	Twin Momentum: Fundamental Trends Matter
Meb Faber	Shareholder Yield Investor	Shareholder Yield
James O'Shaughnessy	Value Composite Investor	What Works on Wall Street (4th Ed)
Validea	Private Equity Investor	Leveraged Small Value Equities
Validea	Momentum Investor	Validea Internal