



2007 GURU PORTFOLIO PERFORMANCE REPORT

REVIEW AND ANALYSIS OF VALIDEA'S
GURU-BASED MODEL PORTFOLIOS

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2007 MARKET OVERVIEW

In 2007, the solid gains made by most major stock indexes belied some significant disparities in the market's performance. From the start of the year to mid-July, for example, the Dow Jones Industrial Average was up about 12 percent, while the S&P 500 had gained almost 10 percent. But after the subprime mortgage and credit crises finally boiled over into the broader market in mid-to-late-July, each of those indexes dropped by about 5 percent over the remainder of the year.

Another major disparity during the year involved the gap between growth and value stocks. While extensive research shows that value stocks tend to outperform growth companies over the long term, the opposite occurred in 2007. According to Morningstar, the average value fund dropped slightly less than 1 percent, while the average growth fund delivered market-beating returns. A major factor in value investors' struggles was financial stocks. Normally the type of steady, solid firms that value strategies covet, financials were down more than 20 percent in 2007 as the subprime and credit crises left many big banks and brokerages writing off billions of dollars in loan losses.

After all was said and done, the Dow Jones Industrial Average finished 2007 at 13,264.82, up about 6.4 percent, while the S&P 500 closed at 1,468.36, a more modest 3.5 percent gain. The technology-heavy NASDAQ index performed better, rising 9.8 percent. The Russell 2000 Index, meanwhile, fell almost 3 percent, highlighting smaller stocks' struggles during the year.

Among our guru-based models, there were also some major disparities in 2007. Four of the models beat the S&P 500 and seven lagged it, but most of the winners won big. Three models -- those that I base on the writings of a famed Momentum Investor, The Motley Fool's Gardner brothers, and Kenneth Fisher -- grew at least 19 percent, gaining between five and ten times the S&P. Here's a look at a wide swath of the guru models, including both the strong performers and some good long-term strategies that struggled in 2007.

2007 VALUE STRATEGIES

The Kenneth Fisher Strategy

It was another banner year for my Fisher-based model, which followed up its 40 percent gain in 2006 (nearly three times the gain of the S&P 500) with a 19.1 percent jump in 2007 (more than five times the S&P).

This model centers on the Price/Sales-focused approach Fisher laid out in his book "Super Stocks". While the Price/Earnings ratio is probably the most well-known financial variable used by investors, Fisher found that earnings, even for good companies, can be highly volatile. Changes in accounting rules, changes in the amount of research and development a company does, changes in tax rates, and many other changes can affect earnings from year to year or quarter to quarter; sales rarely decline for top-flight businesses, however, Fisher noted.

As a result, a company with troubled earnings but strong sales is a company Fisher may well want to own. If a company has a low Price/Sales Ratio (PSR), a slight improvement in margins can produce a big gain in earnings (and a big gain in stock price).

The Fisher model is now one of my best-performing models since its inception, and it has performed particularly well over the past two years. But while 2006 and 2007 were very strong years for it, the model was actually in the red in 2005, dropping 2.7 percent that year compared to the 3 percent gain of the S&P. It is thus a prime example of why sticking with a strategy through good times and bad is so critical. Had I given up on the model because of its 2005 performance, I'd have missed out on the tremendous gains it has produced over the past two years.

A big part of the Fisher model's 2007 success centered around steel and other metals. The strategy picked up Schnitzer Steel Industries on July 14 and sold it less than three months later on Oct. 5 for a 109.2 percent gain. It also held Gerdau Ameristeel for about three months, during which time the stock soared 34.1 percent. In addition, the strategy held Quanex Corporation, which produces a variety of metal and wood products, from the beginning of the year through March 23, when the stock jumped 22.9 percent, and again for 28 days in November, during which time it jumped another 24.8 percent. (Interestingly, during the seven-plus months in between these periods, when the Fisher model did not own Quanex, the stock was in the red.)

The David Dreman Strategy

Coming into 2007, the Contrarian strategy that I base on Dreman's writings had been my best performer. By scouring the market for fundamentally strong stocks that had been beaten down because of apathy or overreaction, this deep value approach had gained over 180 percent -- more than four times the S&P 500 -- from its July 2003 inception through 2006.

But every strategy goes out of favor sometimes, and 2007 was particularly hard on value approaches. A big reason for that was the turmoil that the subprime mortgage and credit crises caused in the financial sector. As noted above, these financials are normally home to the type of steady, solid investments that value strategies can rely on in uncertain markets, but this time they were the cause of the market's unrest. In large part due to the financial sector's troubles, the Dreman model dropped 12 percent in 2007, the first year since its inception that it hadn't at least doubled the market's gains.

Driving the model's sub par returns were financials like the Bank of Ireland, Barclays, Lehman Brothers, and First Marblehead, all of which posted double-digit losses during the

time the strategy held them in 2007. The model was protected against deeper losses by energy stocks, however, selecting such strong gainers as BP, Eni SpA, and CPFL Energia.

While 2007 was a rough year for this model, it still has one of the best long-term track records of all my strategies, more than tripling the S&P 500 since its inception. In addition, its beta is hovering around 1.0, meaning that it has been no more volatile than the broader market while posting those impressive long-term gains. Also, remember that Dreman's approach feeds off the fear and overreaction that occur on Wall Street, be it fear about a particular stock, an industry, or the market as a whole. Lately, there has been a lot of trepidation among investors because of the subprime and credit crises, and quite a few stocks are now selling well below their historical levels and underlying values. As those messes get sorted out, expect this model to be one of the first to find winners on the scrap heap, and one of the first to reap the benefits of the turnaround.

TOP 2007 GROWTH STRATEGIES

The Momentum Investor Strategy

If ever there were an example of why it is so important to stick with a strategy for the long term, Validea's Momentum Investor model's performance last year would be it. In 2006, the model was the only one of my strategies not to outperform the market (and frankly it wasn't close, posting a -15.2 percent return). But this past year it bounced back strongly -- very strongly. The strategy was by far my best performer in 2007, gaining 37 percent -- more than 10 times the S&P 500. If you'd followed this model in 2006 and panicked and abandoned it after its poor performance, you'd have missed out on some tremendous gains in 2007.

The reason for the Momentum Investor model's success this year: momentum. While this approach does use a few value-based criteria, it mainly centers on finding companies whose earnings and stock price have both been rising dramatically of late -- those with the most momentum. And in 2007, momentum reigned in the market. According to Legg Mason fund manager Bill Miller, the 50 stocks that posted the greatest price gains from 2004-2006 produced returns that doubled the market in 2007; what had been going up kept going up, and that played right into my Momentum Investor's hands.

Some of the biggest gainers that this strategy uncovered were mobile communications companies. Mobile Telesystems, a mobile phone company that operates in Russia and several other former Soviet republics, jumped 71.5 percent from the time the strategy selected it to the end of the year. And Research in Motion, the developer of the BlackBerry, gained 71.6 percent during the 12-week period in which it was held in the portfolio.

The Momentum Investor model is a good long-term strategy; it's nearly doubled the S&P over the past four-plus years. But as this model has shown over the past two years, even good strategies can go out of favor over the short term. You simply can't predict what the market will do from year to year, so I'm not going to count on this strategy returning ten

times the S&P again in 2008. But I will stick with it, because over the long-term it has proven to outperform the market. That's the real test of any strategy.

The Motley Fool Strategy

Fourteen years after brothers Tom and David Gardner created their Motley Fool investment newsletter, their business has grown into an online empire. Millions of people view the Fool's web site every month, seeking out the quirky, often irreverent advice that the Gardner brothers and their colleagues offer.

The Fool's advice paid off quite well for Validea this year. The strategy I base on the Gardner brother's *Motley Fool Investment Guide: How the Fools Beat Wall Street's Wise Men and How You Can Too*, returned 23.3 percent in 2007 -- more than six times the S&P 500. While any strategy will inevitably go through down years, my Fool-based model has yet to experience one. In fact, while seven of my eight original guru models have outperformed the S&P 500 since their inceptions, the Fool-based strategy is one of only two that has beaten the S&P every year.

The Fool approach centers on finding the stocks of small, fast-growing companies that have solid fundamentals. Healthy profit margins, low debt, strong cash flows, and good research and development budgets are all important to the strategy, which also uses the Price/Earnings-to-Growth ratio to help avoid fast-growing but overpriced stocks. Because it is a growth strategy that focuses on small-capitalization stocks, the Fool approach tends to be one of my more volatile models. Its beta since its inception four-plus years ago is 1.45; in 2007, it was 1.35, meaning that it was 35 percent more volatile than the broader market.

The relatively high volatility was worth it in 2007, however, as the strategy identified a number of winners. One of the biggest was Research In Motion, the Canadian technology company that makes the popular BlackBerry phone. After my Fool model picked it up on April 20, Research In Motion soared more than 150 percent for the rest of the year.

Two other international stocks -- Credicorp and Quintana Maritime Limited -- helped the Fool-based model rack up strong gains in 2007. Credicorp, whose main subsidiary is Banco de Credito del Peru, gained 51.3 percent after the strategy snatched it up in February, while Quintana, a Greek shipping company that transports coal, grain, and other bulk commodities, jumped 45.7 percent in the two months the Fool strategy held it.

Martin Zweig Strategy

With a strong finish to the year, my Zweig-based model ensured that it, like my Motley Fool strategy, kept up its streak of beating the market in each year since its inception. Its gains weren't huge -- 5.2 percent -- but they still trumped the S&P 500's 3.5 percent increase.

The Zweig strategy targets stocks whose Price/Earnings ratios aren't too high or too low (Zweig believed a very low P/E wasn't necessarily a sign of a bargain, but potentially a sign of a weak company). It is also heavily focused on earnings, looking for companies that have posted several years of strong profits that have been accelerating of late.

In 2007, the Zweig-inspired model found winners in a variety of different industries. And, despite being the least accurate of my models (only 39.3 percent of its picks gained ended up gaining ground while in the portfolio), the strategy beat the market and posted the fourth-best performance of all my individual guru models. That's because when it worked, it worked very, very well. Leading the way were firms like A.G. Edwards, the regional brokerage that was bought out by Wachovia in the middle of 2007, and Baidu.com, the Chinese Internet giant. A.G. Edwards gained more than 33 percent in the five-month period this model held it, while Baidu.com jumped 32.4 percent in just two months that the Zweig strategy owned it. Clothing retailer Aeropostale, meanwhile climbed almost 20 percent in November and December while the portfolio held it, and Luxembourg-based steel producer ArcelorMittal gained about 22 percent in its lone month in the portfolio. These types of strong, concentrated gains across a variety of industries kept the portfolio in good shape throughout the year.

CONSENSUS STRATEGIES

Top 5 Gurus Strategy

It was an interesting year for Validea's consensus strategies. While the Hot List (which I'll examine below) struggled, the Top 5 Gurus Strategy outperformed the S&P 500, gaining 5.5 percent for the year compared to the S&P's 3.5 percent. This model takes the five strategies that have the best historical risk-adjusted performance and selects each of those models' two highest-rated stocks.

The Top 5 Gurus model found value in a number of places in the market in 2007, especially the energy sector. Among its biggest gainers were energy giant BHP Billiton, which rose 32.2 percent in the less-than-four-months that the strategy held it; Western Refining, which gained more than 34 percent during the March 23-June 15 period it was in the portfolio (though it did give back a bit of those gains when it reappeared in the portfolio from Aug. 10-Sept. 7 and dropped 7.3 percent); and Marathon Oil, which jumped about 16 percent even though it was held for just one month. Other winners included video rental company Netflix, which gained 22 percent in a mere 28 days and Credicorp, the Peruvian banking upstart that gained more than 19 percent after being picked up in July.

Validea Hot List

The last strategy we'll look at is our flagship model, the Validea Hot List. The Hot List is a ten-stock portfolio that identifies the top stocks in the market using a blend of all my individual guru strategies, giving more weight to those models that have had the best risk-adjusted results. By looking for overlap among these proven, diverse individual strategies, the Hot List limits the amount of risk that it's susceptible to should one particular approach go out of style for a period. And, by using a varied group of models that focus on a wide array of fundamentals, it is designed to pick only the most fundamentally sound stocks in the market.

Because most of the strategies underlying the Hot List are value based rather than growth based (remember, history shows that value outperforms growth over the long term), the model struggled in 2007. For the first time since its inception, it lagged the market,

dropping 11.6 percent; in the previous three-and-a-half years it had more than quadrupled the S&P 500. At the heart of the rough year were financials. Big banks -- normally the kind of steady, value-based stocks that the Hot List takes advantage of -- were hit hard by the subprime crisis. The portfolio held onto or pursued a number of financials while their prices were dropping, seeing them as good value plays. But as these banks wrote off more and more bad debt -- much of which had been parked off their balance sheets -- they continued to languish.

A few financials in particular hurt the portfolio: Citigroup dropped 29.1 percent during the Aug. 10-Nov. 30 period that it was held; Wachovia lost 23.6 percent while in the portfolio from Jan. 26 to Nov. 30; and Barclays dropped a shade under 20 percent during its six-plus month stay in the Hot List.

Among the winners the Hot List identified were China Petroleum & Chemical Corp., which jumped almost 19 percent over its five-and-a-half months in the portfolio, and clothing retailer Aeropostale, which gained 16.7 percent in a short 28-day stay in the Hot List in November. Energy firm Eni SpA also fared well in two stints, gaining about 15 percent from the start of the year through July 13, and then jumping another 10 percent when it re-entered the portfolio from Aug. 10-Oct. 5.

The Hot List remains one of my best performers over the long term, still having more than tripled the S&P 500's gains since its inception. But, like all of my strategies, it is constructed to perform well over the long haul, and is not immune to short-term periods of underperformance. As I've noted before, none of the gurus were day traders. The stock market and economy are far too complex for anyone to always know which way they are going, and trying to beat the market by timing it is a huge gamble. All of our investment strategies were developed on the principle that investing for the long term is a safer -- and more profitable -- way to make money in the stock market, a sentiment that gurus like Peter Lynch or Warren Buffett have long espoused. (Even they have had years when they've lagged the market.)

If you try to jump from hot strategy to hot strategy, you'll ultimately be left buying high and selling low, and chasing returns with little success. The best investors of all time have made their fortunes by developing solid, long-term strategies and sticking with them in good times and bad. Yes, that means you'll have to deal with short-term periods of discomfort; there's no such thing as free and easy money. Those stomach-churning short-term periods are the price we pay for investing in and reaping the benefits of the stock market, which has proven to be the most successful long-term investment vehicle in history. And over the long term, I'm confident that each of our models will continue to prove themselves as solid, market-beating strategies.

To view the 2007 model portfolio results, as well as the full historical record of all of Validea's strategies, please [click here](#) to view our model portfolios.