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SPECIAL REPORT

Telling You What Wall Street Doesn't Want You To Know

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ABOUT MARKET MYTHS

THESE ARE ARTICLES THAT WILL ADDRESS INVESTING STRATEGIES, UNCOVER TRUTHS ABOUT MONEY MANAGEMENT AND HELP GUIDE YOU THROUGH THE TRAPS AND PITFALLS OF PLANNING AND SAVING FOR RETIREMENT.

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THE VALUE OF VALUE INVESTING by Lance Roberts

It is very important to your success as an investor to understand a little bit about fundamental valuations in relation to the stock market. Today's discussion will be brief and to the point with examples – but if you want a more thorough understanding of fundamental analysis and modern portfolio theory as it applies to building a portfolio then you should take some timeto visit the Streettalk University. Just click the icon on the front page at www.streettalklive.com.

A Dropped Ball Bounces

Earnings are the life blood of companies and earnings are what you are buying when you invest in company stock. *(Click Here For How To Read An Earnings Report)*

Knowing what you are paying for earnings is how you avoid most of the major market corrections when they occur. Think back to March of 2000 – why did the markets correct so sharply? Was it really because of the terrorist attack, the tensions between Pakistan and India, corporate malfeasance or the threat of deflation – or were these events just catalyst to correct the excesses that were contained in the markets from the *"irrational exuberance"* of the 90's? One thing is for sure – corporate earnings corrected sharply. Very sharply.

It is important to understand the basics of fundamental valuations because while earnings growth after a cyclical earnings recession may be good –if it isn't put into the proper perspective when investing— it can lead you to make faulty assumptions about the true health of the company. The ramifications of an earnings recovery versus long term sustainable growth are vastly different and should be reflected in your investment decisions in terms of your investment time horizon.

For instance, if I drop a ball off a 20-story building and it bounces off of the pavement to the 4th floor, my ball has had a 20% recovery. From a percentage recovery it sounds terrific but the ball is still significantly below the 20th floor. It is the same way with corporate earnings, let's look at an example:

INTEL (INTC) EARNINGS REPORT											
Year	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*
Annual Sales	29.389	33.726	26.539	26.764	30.14	34.21	38.83	35.38	38.33	37.59	35.13
Sales Growth	11.86%	14.76%	(-21.31%)	0.85%	12.61%	13.50%	13.50%	(-8.88%)	8.34%	(-1.93%)	(-6.54%)
Annual EPS	1.06	1.51	0.19	0.46	0.86	1.17	1.42	0.87	1.2	0.93	0.79
EPS Growth %	21.84%	42.45%	(-87.42%)	142.11%	86.96%	36.05%	21.37%	(-38.73%)	37.93%	(-22.50%)	(-15.05%)

As you will see in 2000 Intel earned $1.51 per share on $33.726 billion in sales, but in 2001 those earnings were slashed to only $.19 per share which was over an 87% decline versus only a 21% decline revenue. That's the drop from the 20th floor. You see the same thing again in 2008 as EPS growth declined 22.5% versus a 1.9% decline in revenue.

You will then notice that in 2002 earnings began to recover – sales jumped an astounding 0.85% and bottom line earnings per share recovered to 1/3 of their 2000 level – but that was a 142% increase over the previous year. Is that organic earnings growth or cost cutting? You see the same thing in 2008-2009 if EPS growth jumps in the coming years without a subsequent rise in revenue questions should be asked about the health of that growth rate in earnings.

Therefore, it becomes a "glass half empty / half full" debate as you try to figure out where to put your money.

When investing – don't be deceived by listening to the market "talking heads" about the great growth that a particular tech company has had. As you will see, in the examples to follow, year over year earnings growth above 15% is unsustainable over the long term.

Earnings Deceleration & The Second Differential

Once the ball has bounced off of the earnings pavement the company will most likely reach the pinnacle of that bounce within twelve to eighteen months. As you will notice in the chart to the right – Intel has grown earnings at an average of about 8.74% annually over the 16 years shown which includes the recession of 2000 -2001 and 2008-2009. As you will see the big jump in earnings growth failed to replicate after 2004 and in fact has been on a sequential decline since.

INTC 16 YR SALES			
Year		Sales	Growth %
1994	$	11.52	
1995	$	16.20	40.63%
1996	$	20.85	28.67%
1997	$	25.07	20.26%
1998	$	26.27	4.80%
1999	$	29.39	11.86%
2000	$	33.73	14.76%
2001	$	26.54	(-21.31%)
2002	$	26.76	0.85%
2003	$	30.14	12.61%
2004	$	34.21	13.50%
2005	$	38.83	13.50%
2006	$	35.38	(-8.88%)
2007	$	38.33	8.34%
2008	$	37.59	(-1.93%)
2009	$	35.13	(-6.54%)
AVG	**$**	**29.12**	**8.74%**

The initial benefit to the corporate earnings picture after a cyclical earnings recession (as in 2001 and 2002 in our INTC example) are the extremely easy year-over-year comparisons. In our example to the right, Intel grew their 2003 earnings by over 12% to $30, however, this is still a far cry below their 2000 earnings of almost $34. Finally in 2006 earnings exceeded the 2000 level and are barely unchanged from that level in 2009.

The key to the markets, analysts and you, as an investor, is what is known as the ***"Second Differential"***.

Second Differential = The Change In The Rate Of Change

Let's go back to our example: In 2007, Intel earned $38.33 which was an increase of 8.34% over 2006 earnings of $35.38. However, in 2008 earnings fell to $37.59 which was a 1.93% decrease over the previous year. In 2009, Intel earned slightly less than in it did in 2006, which was $35.13 per share; and was a 6.54% decrease from 2008. This is called ***"Earnings Deceleration"*** and is not a factor of true corporate health – however, Wall Street is focused on the ***"Second Differential"*** which is the earnings growth from the previous year (the change in the rate of change).

This is inevitable as companies grow – if a company earns $1 in year one, then $2 in year two the company experienced a 100% earnings growth rate. However in year three if they earn $3 the company will have only grown earnings by 50% which is sharp decrease in the rate of change in earnings – but that does not necessarily mean the company in fundamentally unsound.

This is where the going gets tougher for companies. Wall Street continually over-optimistically forecasts earnings for the markets. A long-term study published by the National Bureau of Economic Research shows that analysts typically overstate earnings by at least a factor of 2. From the report: *"Analysts predicted a five-year growth for the top 20% of companies to be 22.4% which turned out to be only 9.5%."*

They created sample portfolios based upon analysts' forecasts. Predictably, the top portion of the portfolios actually returned only about half of what the analysts predicted: 11% actual versus 22% predicted. *"These results suggest that in general caution should be exercised before relying too heavily on long-term forecasts as estimates of expected growth in valuation studies."*

Finding Value In What You Own

Scott McNealy, the chairman of Sun Microsystems (SUNW) was once quoted as saying; "*At 10 times revenues? Do the math. There is no way to justify anything. Two (2) times revenue implies a 15% annual compound growth rate forever. Jack Welch (Chairman of GE at that time) did that for 20 years and went down as the greatest CEO ever. So what does 10 times revenues require?"*

So, if at two (2) times revenues requires a 15% annual compound growth rate **FOREVER**, what does eight (8) times revenues require? ***Somewhere in the neighborhood of an 80% annual compound growth rate***…and you wonder why we are a little skeptical about market valuations currently with the S&P 500 trading at 2.13 times revenue but with earnings growth over the next 3-5 years estimated to be closer to 6% versus 15%.

If, two (2) times revenue is high – then what are some historical benchmarks for finding companies trading near some reasonable valuation? Here are some classic yardsticks with long and venerable track records.

Price to Earnings <= 20 - Also known as the P/E multiple, this is the latest closing price divided by the latest 12 months' earnings per share. P/E is perhaps the single most widely used factor in assessing whether a stock is pricey or cheap. A high P/E is often a reflection of lofty expectations for a stock, since no one would invest knowing it would take 40 years just to make one's money back. The idea is that earnings will grow. A high P/E can also reflect poor recent earnings. A low P/E can imply low investor expectations, an undervalued stock, or both. P/E's of stocks should be compared with *other companies in its peer group – but should not on the whole greatly exceed the P/E of the index.*

Price to Cash Flow >0 - The closing price divided by cash flow per share from the last 12 months. An alternative to the P/E ratio, this one removes depreciation and other non-cash charges from the equation, and can be especially useful in businesses with huge depreciation expenses, such as the cable TV industry. Finding companies with positive cash flow is critical.

Price to Sales <= 1.5 - The latest closing price of the stock divided by the latest 12 months' sales per share. In recent years, investment theorists have paid increasing attention to sales as an indicator of a company's prospects. James O'Shaughnessy is a particular proponent of the price/sales ratio; if this number is below 1.5, he considers it an indicator that the stock is undervalued.

Price to Book <= 2 - The latest closing price of the stock divided by the most recent quarter's book value per share. (Book value is simply assets minus liabilities.) Also known as the price/equity ratio. A favorite of strict value investors, the price/book ratio gives some idea of whether you're paying a little or a lot for what would be left of the company if it went out of business immediately.

Price to Earnings Growth (PEG) <= 1.5 - The price/earnings (P/E) ratio divided by expected per-share earnings growth over the coming year. A value of less than 1 implies that the stock may well be undervalued; more than 1 implies that it is overvalued.

Now that we have some guidelines to follow, we can begin to analyze the companies that we own. Let's take a look at some of the better known and highly traded companies on the Nasdaq.

NASDAQ STOCKS		Current Price	Avg Est Tgt Price	% To Tgt Price	Trail 12 P/E Ratio	Fwrd 12 P/E Ratio	Price / Book	Price / Cash Flow	Price / Sales	3-5 Year EPS	PEG
ISRG	INTUITIVE SURG	321.25	450.00	40.1%	43.83	34.40	7.07	44.00	10.55	24.83	1.52
BIDU	BAIDU INC	72.43	95.00	31.2%	96.57	45.11	24.64	71.55	26.41	45.98	1.27
INFY	INFOSYS TEC-ADR	61.34	73.00	19.0%	26.67	23.60	7.23	24.69	7.29	18.63	1.31
GOOG	GOOGLE INC-CL A	456.56	755.00	65.4%	20.77	17.01	3.79	17.53	5.83	22.33	0.82
CTSH	COGNIZANT TECH	52.74	61.00	15.7%	28.05	23.46	5.44	29.06	4.49	17.83	1.40
ORCL	ORACLE CORP	23.22	40.00	72.3%	14.60	12.47	3.74	11.27	4.35	13.77	0.92
AAPL	APPLE INC	258.09	390.00	51.1%	21.91	16.46	5.95	25.78	4.59	18.00	1.04
CTXS	CITRIX SYS INC	44.70	60.00	34.2%	30.00	28.57	3.52	20.81	5.00	11.56	2.66
VRSN	VERISIGN INC	27.99	40.00	42.9%	23.92	22.26	8.12	16.16	4.90	10.00	2.44
ORCL	ORACLE CORP	23.22	40.00	72.3%	14.60	12.47	3.74	11.27	4.35	13.77	0.92
		AVERAGES		**44.4%**	**32.09**	**23.58**	**7.32**	**27.21**	**7.78**	**19.67**	**1.43**

Well, not much in the way of value there. If Scott McNealy is right then AAPL which has one of the better price to sales ratios (PSR) of the group ***will need to have earnings growth of around 50% compounded annually just to maintain the current PSR*** – that may be difficult to do given that they are expected to grow at 18% annually over the next 5 years which would barely justify a PSR of 2.

Furthermore, every single other metric of our yardsticks for value investing are completely skewed. Intuitive Surgical (ISRG), for example, is a stock trading at 150 times trailing 12 month earnings with a PSR of over 10.

Apple, Inc. has been a winner in the markets after posting a huge price decline in 2008. While the company is currently growing earnings at a very fast clip the problem becomes that nasty "second differential" in growth rates as the company gets bigger. Investors are still chasing the stock even though expected earnings over the next 3-5 years are half of what the company has done over the past 3.

With a P/E ratio of 21 times last year's earnings, a PSR of 4.59 and a Price to Book Value (P/B) ratio of over 5, AAPL will need to maintain an average compound annual growth rate of earnings in excess of 50% per year just to stay even. Again, with AAPL now heading into a mature business phase with heavy competition from GOOG and other smart phone and device makers like RIMM and an estimated earnings growth rate of 18% annually – it just doesn't fit.

As you will notice right off the bat – not one stock on the above list would qualify for purchase. However, investors are willing to pay a massive premium to own them. Why? We will discuss this issue later on.

How 'Bout A Dog

If you can't find value on the Nasdaq – how about some of the Dogs of the Dow. Surely, within the most beaten up stocks on the Dow Jones Industrial Average there must be value, right? Let's see.

DOGS OF THE DOW		Current Price	Avg Est Tgt Price	% To Tgt Price	Trail 12 P/E Ratio	Fwrd 12 P/E Ratio	Price / Book	Price / Cash Flow	Price / Sales	3-5 Year EPS	PEG
T	AT&T INC	24.57	34.00	38.4%	11.38	10.43	1.42	4.50	1.18	5.93	1.83
VZ	VERIZON COMM	26.78	36.00	34.4%	11.49	11.66	0.90	3.26	0.70	5.25	2.29
DD	DU PONT (EI) DE	36.29	50.00	37.8%	13.24	13.00	4.42	9.76	1.15	8.67	1.59
KFT	KRAFT FOODS INC	29.03	37.00	27.5%	14.09	13.40	1.25	10.90	1.02	8.00	1.80
MRK	MERCK & CO INC	35.86	48.00	33.9%	10.70	9.92	1.85	10.93	3.34	4.88	2.18
CVX	CHEVRON CORP	70.41	105.00	49.1%	10.87	7.51	1.47	14.59	0.77	8.49	0.94
MCD	MCDONALDS CORP	69.02	90.00	30.4%	16.51	14.76	5.26	13.25	3.19	9.23	1.67
PFE	PFIZER INC	14.82	30.00	102.4%	7.13	6.71	1.33	6.31	2.14	1.79	3.83
HD	HOME DEPOT	28.15	45.00	59.9%	15.90	13.65	2.46	10.37	0.71	11.50	1.27
BA	BOEING CO	64.73	101.00	56.0%	38.99	14.69	16.12	15.61	0.73	13.50	1.24
		AVERAGES		47.0%	15.03	11.57	3.65	9.95	1.49	7.72	1.86

The reason that the **Dogs of the Dow Strategy** works is that it has a forced active management discipline attached to it. This strategy also works by trying to ferret out value in an otherwise potentially overvalued index.

With a P/E Ratio on the entire group in the 15 times earnings area and a PSR close to our value yardstick of a 1.5 multiple – we at least have a more reasonable expectation of making money in the future while protecting principal. That is one reason the Dow was never hurt as badly during the correction in 2000 to 2002 as compared to the Nasdaq and the same in 2007-2008.

Still – even these lowly stocks miss many of our benchmark valuations. Does this mean that our criteria are too stringent? The only stocks that are value plays are stocks that no one wants to own? The answer to both of these questions is simply – NO.

Value & Return

I ran a screen against our database of over 8000 stocks with every one of our yardstick criteria involved. I got a listing of over 400 stocks that met every one of our value metrics. That is quite a few to choose from and you're right – not all them are winners – sometimes stocks **ARE** cheap for a reason.

I then whittled down the list looking for stocks with a Market Capitalization greater than $1 Billion and had to pay a dividend in order to get rid of speculative start up companies. Furthermore, the company had to have an average of analysts rating of "Buy".

What does that mean? Just because these stocks look good fundamentally – does that mean they are good buys?

Technical Analysis

This is where technical analysis yields its greatest potential. While fundamental analysis can tell you **WHAT** to buy – technical analysis will tell you **WHEN** to buy it. ***Remember – it is never a question of IF you should invest in the markets – it is always a question of WHEN that separates the successful investors from the broke ones.***

But Does It Work?

I know a lot of you are thinking – *"…yea, this all sounds good and dandy but would it have made me any money…"*

That is a good question and I took that question to task. I built a hypothetical starting portfolio and went back five years 7/2005 – 7/2009 to see how the portfolio would have done against the S&P 500. The portfolio was rebalanced only once every 4 weeks to keep turnover down and stocks that no longer fit our criteria were removed and replaced with new entrants.

Here are the results.

In the chart below you will see the portfolio had a significant level of outperformance over the five year back testing period beating the S&P 500 by a whopping 25.9% compounded return.

NOTE: *Did you notice that the S&P had only 0.6% return over that same period. A 10-Year Government bond would have beaten the S&P 500 on a total return basis over that period.*

Educational Purposes Only - Not Recommend For Use		P/E Ratio	Price / Cash	Price / Sales	Price / Book	PEG Ratio	Div Yield
CONSUMER STAPLES							
Gannett Inc	GCI	6.84	5	0.62	1.87	1.18	1.1
Service Corp In	SCI	14.65	6.3	0.94	1.27	1.38	2.1
CONSUMER DISCRETIONARY							
Carnival Corp	CCL	14.97	6.36	1.43	0.94	0.9	1.27
Cinemark Hldgs	CNK	11.33	5.28	0.76	1.65	1.36	5.17
Comcast Cla Spl	CMCSK	13.89	15.44	1.35	1.14	0.87	2.25
Jarden Corp	JAH	10.75	6.54	0.49	1.48	1.11	1.2
Leggett & Platt	LEG	19.08	11.49	0.96	1.97	1.09	5.09
Phillips Van He	PVH	15.28	12.43	1.29	1.64	1.03	0.32
Snap-On Inc	SNA	18.07	11.74	1.02	1.91	1.49	2.83
Time Warner Inc	TWX	13.33	3.53	1.22	1.02	1.02	2.87
RETAIL-WHOLESALE							
Cash Am Intl	CSH	10.44	7.35	0.89	1.44	0.66	0.4
Cvs Caremark Cp	CVS	10.94	7.74	0.4	1.15	0.82	1.19
Lowes Cos	LOW	16.18	8.36	0.61	1.54	1.24	1.78
Ruddick Corp	RDK	15.83	7.24	0.38	1.84	1.28	1.48
MEDICAL							
Aetna Inc-New	AET	10.84	7.55	0.34	1.2	1.05	0.15
Omnicare Inc	OCR	8.96	6.16	0.47	0.74	0.73	0.37
Univl Hlth Svcs	UHS	14.49	8.02	0.69	1.75	1.41	0.54
AUTO-TIRES-TRUCKS							
Johnson Control	JCI	18.38	30.36	0.61	1.99	0.88	1.83
Spx Corp	SPW	15.31	5.34	0.56	1.44	1.2	1.87
BASIC MATERIALS							
Archer Daniels	ADM	10.99	7	0.28	1.16	0.93	2.25
Olin Corp	OLN	19.41	9.99	1	1.81	1.08	4.25
INDUSTRIAL PRODUCTS							
Dover Corp	DOV	18.79	12.88	1.36	1.99	1.29	2.39
Smith (Ao) Corp	AOS	14.56	10.64	0.77	1.9	0.66	1.52
CONSTRUCTION							
Rpm Intl Inc	RPM	13.54	10.04	0.72	1.97	0.79	4.45
COMPUTER AND TECHNOLOGY							
Jabil Circuit	JBL	17.14	2.08	0.24	1.97	0.7	2.04
Teleflex Inc	TFX	14.74	8.55	1.16	1.39	1.15	2.46
Tyco Electr-Ltd	TEL	15.73	12.74	1.02	1.68	0.78	2.58
Xerox Corp	XRX	11.19	5.8	0.69	0.99	-0.34	2.08
AEROSPACE							
Genl Dynamics	GD	9.82	7.92	0.75	1.83	1.25	2.76
Raytheon Co	RTN	9.98	9.72	0.75	1.83	1.18	3.03
OILS-ENERGY							
Chevron Corp	CVX	10.87	14.59	0.77	1.47	0.94	4.09
Conocophillips	COP	11.46	5.07	0.46	1.21	1.18	4.27
Hess Corp	HES	14.24	6.12	0.56	1.27	1.28	0.74
Natl Oilwell Vr	NOV	9.11	7.05	1.22	1.02	0.6	1.12
Petrobras-Adr C	PBR	9.08	4.18	0.81	0.97	1.17	0.41
Questar	STR	6.07	2.34	0.92	0.73	1.46	3.2
Royal Dtch Sh-A	RDS.A	12.91	6.74	0.53	1.18	1.39	5.36
Williams Cos	WMB	17.69	5.51	1.28	1.24	0.92	2.62
FINANCE							
Aarons Inc	AAN	12.37	2.22	0.79	1.52	0.92	0.28
Ace Limited	ACE	6.64	6.25	1.19	0.86	0.64	0.59
Amer Finl Group	AFG	7.1	4.81	0.73	0.75	0.98	1.92
Ameriprise Finl	AMP	11.48	8.68	1.17	0.91	0.89	1.88
Aspen Ins Hldgs	AHL	6.53	4.52	0.98	0.65	0.63	2.33
Axis Cap Hldgs	AXS	6.58	5.28	1.35	0.83	0.54	2.71
Banco Bradesco	BBD	13.72	12.75	0.89	1.33	1.26	0.53
Credit Suisse	CS	8.98	8.15	1.35	1.11	0.86	2.76
Goldman Sachs	GS	5.65	4.54	1.36	1.08	0.78	1.03
Hanover Insuran	THG	13.65	11.7	0.69	0.91	0.8	2.26
Hcc Ins Hldgs	HCC	8.55	7.79	1.23	0.94	1.21	2.13
Lincoln Natl-In	LNC	7.38	8.69	0.88	0.65	1.46	0.16
Metlife Inc	MET	10.6	15.83	0.74	0.9	1.13	1.88
Partnerre Ltd	PRE	6.46	5.83	0.97	0.8	1.31	2.75
Prudential Finl	PRU	9.31	9.7	0.96	0.95	1.04	1.25
Reinsurance Grp	RGA	7.61	11.48	0.46	0.84	0.69	1
Validus Holding	VR	8.3	5.75	1.47	0.87	0.51	3.49
Wells Fargo-New	WFC	15.31	8.85	1.41	1.27	1.4	0.75
Xl Group Plc	XL	6.85	7.43	0.93	0.58	0.73	2.35
UTILITIES							
Hubbell Inc -B	HUB.B	12.73	9.19	1.05	1.84	1.06	3.55
Public Sv Entrp	PEG	11.02	6.61	1.38	1.82	-7.07	4.13
Southn Union Co	SUG	13.34	6.36	1.25	1.16	1.22	2.66
Telus Corp	TU	14.02	2.28	0.6	0.73	0.86	5.08
TRANSPORTATION							
Fedex Corp	FDX	19.54	7.34	0.66	1.67	1.15	0.65
BUSINESS SERVICES							
Abm Industries	ABM	17.22	10.87	0.32	1.59	0.94	2.51
Donnelley (Rr)	RRD	9.65	3.69	0.35	1.56	0.83	6.34
Average		12.25	8.15	0.87	1.34	0.87	2.23

Also, notice that the number of holdings varies during each period. One of the main reasons that active portfolio management works is that it forces you to sell winners and losers thereby protecting gains and limiting losses. **Imagine that – protecting gains and limiting losses – if only CNBC would preach that mantra rather than** *"buy stocks – all day, every day, because that's what our advertisers pay us to tell you."*

A Second Look – Value or Overvalued

So far we have discussed stock valuations and reviewed 20 widely held issues (10 Nasdaq and 10 Dow) and discovered that basically all of the stocks were overvalued relative to a number of factors.

Most investors buy what is hyped on television, the media, and by their brokerage firms. The amount of information overload these days is overwhelming.

Investors tend to speculate rather than invest in the markets and they tend to buy stocks that tend to be overvalued by most measures of investing.

So, what would have happened if we had invested in stocks that were overvalued? These stocks tend to be the ones gaining the most notoriety because of their market position or because they have recently made big upward price movements.

Overvalued and Rising

Take a look at CNBC or any media outlet and you hear about the high flyers. Daily on *"Streettalk"* I am bombarded with questions about stocks that have little or no fundamental value whatsoever – yet these stocks prices have skyrocketed over the last 9 months. What would have happened had you invested in all the hot stocks during that same two year period as our value model above?

Let's see.

First of all we have to change our screening parameters to find all the hot stocks like Netflix, Intuitive Surgical and others. One parameter we are keeping the same as the Value Model is that selected stocks have to have positive cash flow – in other words the companies have to make money.

Period	Date	No. Of Holdings	Portfolio Return %	S&P 500 Return %	Excess Return %
1	7/22/2005	6	-4.5	-1	-3.5
2	8/19/2005	11	5.5	1.6	3.9
3	9/16/2005	5	-2.7	-4	1.3
4	10/14/2005	10	-1.3	4.2	-5.5
5	11/11/2005	11	3.5	2.1	1.4
6	12/9/2005	10	-0.1	2.2	-2.3
7	1/6/2006	12	1.8	-1.5	3.3
8	2/3/2006	20	2.1	2	0.1
9	3/3/2006	16	3.2	0.7	2.5
10	3/31/2006	15	-3.1	1.4	-4.5
11	4/28/2006	15	-5.6	-2.2	-3.5
12	5/26/2006	12	-6.6	-2.6	-4
13	6/23/2006	16	-3.9	-0.2	-3.8
14	7/21/2006	14	4.1	5.1	-1
15	8/18/2006	13	-0.5	1.5	-1.9
16	9/15/2006	13	4.8	3.6	1.2
17	10/13/2006	12	2.4	1.3	1.2
18	11/10/2006	11	4.3	2.2	2
19	12/8/2006	9	-2.7	0.1	-2.9
20	1/5/2007	10	9	2.9	6.1
21	2/2/2007	6	-2.4	-4.1	1.7
22	3/2/2007	8	2.4	2.6	-0.2
23	3/30/2007	4	-0.3	5.3	-5.6
24	4/27/2007	9	-1.5	1.6	-3
25	5/25/2007	7	1.8	-0.7	2.6
26	6/22/2007	10	-3.5	2.2	-5.7
27	7/20/2007	8	-6.7	-5.6	-1.1
28	8/17/2007	12	-1.5	2.8	-4.3
29	9/14/2007	13	-5.4	5.4	-10.8
30	10/12/2007	15	-18.5	-6.8	-11.7
31	11/9/2007	11	6.3	3.7	2.7
32	12/7/2007	9	-16.7	-6	-10.7
33	1/4/2008	9	10.5	-1	11.5
34	2/1/2008	11	-5.2	-4.5	-0.7
35	2/29/2008	11	-3.5	-1	-2.5
36	3/28/2008	14	9.7	6.5	3.2
37	4/25/2008	9	2.5	-1.4	4
38	5/23/2008	10	-5.3	-4.1	-1.2
39	6/20/2008	12	-10.6	-4.2	-6.4
40	7/18/2008	15	14	3.1	10.9
41	8/15/2008	15	-2.7	-3.4	0.7
42	9/12/2008	15	-37.1	-28	-9.1
43	10/10/2008	31	10.9	3.8	7.1
44	11/7/2008	19	-19	-5.7	-13.3
45	12/5/2008	30	27.4	6.6	20.8
46	1/2/2009	26	-2.3	-11.1	8.8
47	1/30/2009	23	-12.9	-10.7	-2.1
48	2/27/2009	25	24.7	11.3	13.4
49	3/27/2009	22	19	6.4	12.6
50	4/24/2009	19	6.4	2.6	3.8
51	5/22/2009	21	7.1	4.1	3
52	6/19/2009	17	5.1	2.3	2.8
53	7/17/2009	12	17.4	6.9	10.5
54	8/14/2009	16	7.2	4	3.2
55	9/11/2009	8	6.6	2.9	3.7
56	10/9/2009	9	-2.1	-0.1	-2.1
57	11/6/2009	14	2	3.6	-1.6
58	12/4/2009	12	4.1	1	3.2
59	1/1/2010	9	2.3	-3.5	5.9
60	1/29/2010	6	3.6	3	0.6
61	2/26/2010	13	10.5	5.8	4.7
62	3/26/2010	13	7	4.5	2.5
63	4/23/2010	10	-9.5	-10.5	1
64	5/21/2010	17	5	2.9	2.1

	Portfolio	S&P 500	Excess
Annualized Returns	12.3	2.4	9.6
Compounded Returns	26.50	0.60	25.90

Our Screening Parameters

Price to Earnings > 30

Price to Cash Flow > 0 (Company has to make money)

Price to Sales > 3

Price to Book > 2

Price to Earnings Growth (PEG) > 2

These parameters provide for overvalued stocks as you will see in the screening results to the right. Furthermore, remember what Scott McNealy of Sun Microsystems said – a company with a Price to Sales Ratio of 2 – requires an annual compounded growth rate in earnings of 20% just to maintain the current price level of the stock.

Our Screening Results

See, there they all are – the money making hot dogs of the Nasdaq, mostly. Companies such as Netflix, Akamai Technology, F5 Networks, VmWare, Inc. and more – *how many do you own?*

Since these stocks are the cutting edge in technology, surely if you had invested in them, you would have dramatically outpaced the S&P 500 – right?

The Test

When conducting an experiment you have to keep the tests the same between the control group (our value screen) and our test subjects. This helps to ensure that the results you achieve have some basis of validity.

In this case our variables which will remain constant is that we will back test the holdings for a period of 5 years and every 4 weeks the holdings which no longer fit our 5 criteria listed above will be exchanged for new entrants.

Educational Purposes Only - Not Recommend For Use		*P/E Ratio*	*Price / Cash*	*Price / Sales*	*PEG Ratio*	*Price / Book*
CONSUMER DISCRETIONARY						
Dts Inc	DTSI	56.1	44.57	7	2.21	4.11
RETAIL-WHOLESALE						
Loopnet Inc	LOOP	41	26.24	5.63	2.53	3.77
Netflix Inc	NFLX	52.93	17.04	3.45	2.09	42.68
MEDICAL						
Athenahealth In	ATHN	79.42	45.26	3.99	2.32	6.27
Biomarin Pharma	BMRN	158.8	92.36	5.77	8.41	5.61
Luminex Corp	LMNX	83.63	28.03	5.19	2.47	2.98
Merge Healthcar	MRGE	62.4	13.48	3.61	5.11	3.59
Somanetics Corp	SMTS	43.75	44.22	5.51	2.74	3.04
BASIC MATERIALS						
Agnico Eagle	AEM	100	40.53	11.64	2.99	3.19
Eldorado Gold	EGO	49.67	62.39	18.08	9.99	3.23
Titanium Metals	TIE	105.9	39.92	4.35	3.87	3.03
INDUSTRIAL PRODUCTS						
Stratasys Inc	SSYS	60.36	20.56	4.92	2.26	3.58
CONSTRUCTION						
Plum Creek Tmbr	PCL	42.34	17.13	5.02	4.74	3.85
COMPUTER AND TECHNOLOGY						
Advent Software	ADVS	60.05	40.12	4.71	3.59	5.03
Akamai Tech	AKAM	34.4	19.54	8.32	3.09	4.16
Amer Tower Corp	AMT	66.27	28.1	10.53	2.75	5.39
Arcsight Inc	ARST	75.03	52.35	4.22	2.76	5.64
Ariba Inc	ARBA	62.59	36.37	4.46	3.83	3.26
Arm Holdngs Adr	ARMH	63	46.31	11.75	7.96	4.61
Autodesk Inc	ADSK	33.71	20.97	3.2	2.72	3.73
Commvault Systm	CVLT	54.98	44.59	3.68	2.08	6.21
Concur Tech Inc	CNQR	74.9	40.15	8.1	3.19	3.84
Equinix Inc	EQIX	46.34	12.48	3.52	3.26	2.74
F5 Networks Inc	FFIV	53.19	48.82	8.29	2.48	6.77
Netezza Corp	NZ	140.9	92.87	4.28	2.39	4.22
Netlogic Mcrsys	NETL	211.5	60.91	8.04	2.78	3.62
Phase Fwd Inc	PFWD	58	26.2	3.33	2.15	3.02
Rackspace Hostg	RAX	68.39	14.01	3.34	2.28	5.97
Red Hat Inc	RHT	58.75	40.38	7.36	2.94	5.23
Riverbed Tech	RVBD	141.4	74.75	5.05	3.34	5.47
Salesforce.Com	CRM	136.7	57.12	8.56	4.68	10.14
Sourcefire Inc	FIRE	51.81	40.7	4.76	2.36	3.95
Taleo Corp-A	TLEO	56.32	22.3	4.8	2.27	2.86
Vmware Inc-A	VMW	125	70.6	16.53	4.67	9.46
Webmd Health Cp	WBMD	71.91	54.63	5.48	2.95	3.65
OILS-ENERGY						
Eog Res Inc	EOG	36.38	11.64	5.38	3.15	2.64
Range Resources	RRC	58.19	12.07	6.74	5.38	2.63
FINANCE						
Oritani Finl Cp	ORITD	45.41	100.84	5.21	6.38	2.19
BUSINESS SERVICES						
Comscore Inc	SCOR	86.75	38.89	4.03	3.33	3.58
Costar Grp Inc	CSGP	50.13	24.11	3.79	2.27	2.22
Average		72.61	39.89	6.29	3.57	5.22

Overvalued – Underperforming

As you will notice – the overvalued portfolio performed poorly relative to the S&P 500 by having an under performance gap of over 1.6%. Not great.

The reason for the underperformance is that expectations placed on these companies by WallStreet are unattainable and disappointments by these companies are met with vicious sell offs.

Furthermore, all investments return to their fair value at some point in time. If a company has a fair value of $10 per share, but the stock trades at an extreme multiple, the stock will eventually correct itself to its fair value.

While this is just a hypothetical test of an investment strategy – the point is quite clear. When investing in equities – stocks which maintain a high level of valuation cannot maintain such levels for long.

Investors Behaving Badly

The Financial Research Corporation released a study prior to the year 2000 bear market which showed that the average mutual fund's three year return was 10.92% while the average investor in those same periods gained only 8.7%. The reason was simple: ***investors were chasing the hot sectors and funds.***

Of course this makes sense - Investors are only likely to find out about the winners. Indeed, who goes around trying to sell you the losers? You are much more likely to have success hunting on your own.

If you study the next three years, those returns were much worse. The study also found that the current average holding period was around 2.9 years for a typical investor, which is significantly shorter than the 5.5 year holding period of just five years ago.

"Many investors are purchasing funds based on past performance, usually when the fund is at or near its peak. For example, $91 billion of new cash flowed into funds just after they experienced their 'best performing' quarter. In contrast, only $6.5 billion in new money flowed into funds after their worst performing quarter." (from a newsletter by Dunham and Associates)

I have seen numerous studies similar to the one above. They all show the same thing: ***that the average investor does not get average performance. Many studies show statistics which are much worse.***

The study also showed something else; ***Past performance was a good predictor of future relative performance in the fixed income markets and international equity (stock) funds, but there was no statistically significant way to rely on past performance in the domestic (US) stock equity mutual funds.***

The oft-repeated legal disclosure that past performance is no guarantee of future results is true at two levels:

1. **Absolute returns cannot be guaranteed with any confidence.** There is too much variability for each broad asset class over multiple time periods. Stocks in general may provide 5-10% returns during one decade, 10-20% during the next decade and then return back to the 5-10% range.

2. **Absolute rankings also cannot be predicted with any certainty.** This is caused by too much relative variability within specific investment objectives. Top ranked (#1) funds can regress to the average, or fall far below the average, over subsequent periods, replaced by funds that may have had very low rankings at the start.

The higher the ranking and the more narrowly you define that ranking (i.e. #1 vs. top-decile [top 10%] vs. top quartile [top 25%] vs. top half), the more unlikely it is that a fund can repeat at that level. It is extremely unlikely to repeat as #1 in an objective with more than a few funds. It is very difficult to repeat in the top-decile, challenging to repeat in the top quartile, and roughly a coin-toss to repeat in the top half." (Financial Research Center)

In other words, the chances of you picking a stock today that will be in the top 25% of all companies every year for the next ten years is 50 to 1 or worse. ***In fact, the longer a company shows positive earnings growth and outstanding performance, the more likely they are to have an off year. Being on top for extended periods of time is an extremely difficult feat.***

Yet what is the basis for most stock analysts' predictions? Past performance and the optimistic projections of a management that gets compensated with stock options. **What CEO will tell you his stock is over-priced?** His staff and board will kill him, as their options will be worthless. Analysts make the fatally flawed assumption that because a company has grown 25% a year for five years that they will do so for the next five. ***The actual results for the last 50 years show the likelihood of that happening are small.***

What Really Works Over The Long Term

Mark Finn of Vantage Consulting has spent years analyzing trading systems. He is a consultant to large pension funds and Fortune 500 companies. They have run price data through every conceivable program and come away with this conclusion:

Past performance is not indicative of future results.

Actually, Mark says it more bluntly: *"Past performance is pretty much worthless when it comes to trying to figure out the future. The best use of past performance is to determine how a manager or a stock behaved in a particular set of prior circumstances."*

Yet investors read that past performance is not indicative of future results, and then promptly ignore it. They then proceed to chase the latest hot fund or stock, which usually means they are now close to reaching its peak, and will soon top out. This generally occurs shortly after they invest.

What does Finn and his team claim actually works? ***Fundamentals, fundamentals, fundamentals.*** As they look at scores of managers each year, the common thread for success is how they incorporate some set of fundamental analysis into their systems.

Value investing works, it always has and it always will. While there may be times during periods of ***irrational exuberance*** where the great investors of the world like Buffett, Templeton, Graham and others may appear to be wrong – remember, these are the guys that have made more money from investing in the financial markets than anyone – and they kept their money during market meltdowns – ***how did you do?***

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