

VALIDEA

# HOW TO BEAT THE MARKET USING HISTORY'S BEST INVESTMENT STRATEGIES

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JOHN REESE'S GURU-DRIVEN GUIDE TO BEATING THE  
MARKET USING THE VALIDEA HOT LIST

The numbers are staggering: According to studies, as many as 85 percent of active money managers -- *professional* investors, that is -- fail to generate returns that beat the stock market average over the long haul<sup>1</sup>. Despite all the money you pay them in fees and commissions, despite all the confidence they may exude, and despite all the clever advertising their firms may do, the truth of the matter is that, far more often than not, you'd be better off putting your money into an index fund like the S&P 500 than having a professional manage it.

Not that most investors can do any better on their own. In reality, most do far *worse* than those underperforming fund managers. One two-decade-long study actually shows that average investors earn *less than a quarter* of what they would make by just putting their money in a broader index fund<sup>2</sup>.

Sound like a familiar -- and discouraging -- story? It was to me. In fact, I learned both of these lessons the hard way, finding out that neither my own investing instincts nor my advisers' "wisdom" could lead me down the path of market-beating returns.

Those difficult experiences led me on a search to find -- and learn from -- investors who have beaten the market over the long haul. And when I identified these rare stock market "gurus" -- people like Warren Buffett, Benjamin Graham, Martin Zweig, and Peter Lynch -- I discovered something that would forever change my investment experience: Unbeknownst to most investors, many of these gurus not only developed long-term strategies to beat the market -- they also disclosed their approaches in published books or papers!

Using these gurus' wisdom and my own computer expertise, I was able to develop a dozen computerized "Guru Strategies", each of which was based on one of the gurus' approaches. And as I began using these models to pick stocks, I made another pretty amazing discovery: Even though the gurus developed some of these strategies decades ago, they still work today!

The best example of that may be my 10-stock Hot List portfolio, which contains the top ten stocks in the market, as determined by a proprietary model that combines all of my individual Guru Strategies. It takes into account not only how many of my models a stock passes, but also how much historical success those strategies have had. The portfolio gets rebalanced every month, ensuring that it contains the best stocks from the best-performing strategies.

Since its inception in mid-2003, the Hot List has [left the S&P 500 in the dust](#), posting returns that most mutual fund managers would dream of, while taking on levels of risk not all that much greater than the market average. Now that you've signed up for the service, you'll get full real-time access to the names of all the stocks in this market-beating portfolio. In addition, you'll also get my bi-weekly Hot List newsletter, which details these stocks and their performance, offers observations about the economy and the market, and provides broader tips for how you can use my guru-driven investing system to your advantage.

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<sup>1</sup> O'Shaughnessy, James P. *What Works On Wall Street* (Revised Edition). McGraw-Hill, 2005.

<sup>2</sup> DALBAR, Inc. "Quantitative Analysis of Investor Behavior", July 2003.

## The Principles of Guru Investing

Speaking of broader tips, it's important to understand not only how the Hot List and the individual strategies that go into it work, but also the broader concepts behind them -- and how you can get the maximum benefit from them. And that means familiarizing yourself with the key principles of "guru investing", concepts that either led to the development of my models or arose out of my own experiences using them. Let's take a quick look at them now:

- **Don't Try to Re-Invent the Wheel**

There will always be new fads on Wall Street that will work for short periods of time. But in the end, most end up failing. The best way to beat the market, then, is to follow the advice of proven long-term winners. Gurus like Peter Lynch, Benjamin Graham, Martin Zweig, and David Dreman have all been kind enough to give us blueprints explaining how to achieve excellent returns. Why not take advantage of their experience and wisdom?

- **Combine Strategies to Maximize Return and Minimize Risk**

A very limited number of stocks appeal to more than one of these proven investing strategies at any given time. By combining these strategies, as the Hot List does, investors can add an additional level of diversification for a given number of stocks because each strategy looks at a very unique set of criteria. Stocks that get multi-Guru-Strategy approval are thus very strong across a wide range of fundamentals, and history shows that those are the types of stocks most likely to do well.

- **Remove Emotion By Sticking To The Numbers**

Even the most astute investors regularly make mistakes because they let emotion -- not facts and figures -- drive their buy and sell decisions. They buy based on a tip they got from a friend or a relative, or because they read an article that got them excited about a particular company's new product. Similarly, they get spooked by short-term declines and sell strong stocks. And they do all of this without regard to what really drives stock prices over the long haul: the strength or weakness of a company. That often leads to the common mistake of buying high and selling low. If you follow purely quantitative strategies and buy and sell only at regularly scheduled intervals, however, you let the cold, hard numbers tell you how attractive a stock is -- not your fickle, irrational emotions.

- **Use a Proven Strategy -- *And Stick With It***

Market timing simply does not work over the long haul. Stocks and the stock market will fluctuate from day to day based on factors that have little to do with their true strength or weakness, and trying to time those fluctuations is impossible to do with any kind of consistency -- as evidenced by studies showing that market timers do about 40 percent worse than those who use a systematic approach<sup>3</sup>. Over the long term, however, there are systematic strategies proven to beat the market by a wide margin.

That being said, no strategy -- even those used by stock superstars like Lynch and Warren Buffett -- beats the market every month, or even every year. And in today's world of easy Internet access and non-stop, 24-hour

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<sup>3</sup> DALBAR, Inc. "2007 Quantitative Analysis of Investor Behavior".

financial news channels, you're continually bombarded with reminders when your strategy goes through a down period, which can lead to buying high and selling low. A crucial part of stock investing is thus allowing a long-term strategy to work by sticking with it through the short-term ups and downs. How crucial? It's so key that Mark Hulbert says it is the greatest common denominator he's found among successful newsletters in the three decades he's been running the well-respected newsletter tracking service *Hulbert Financial Digest*.<sup>4</sup>

- **You Don't Have to Hold Stocks for the Long-Term to be a Long-Term Investor**

The key to successful long-term investing isn't buying stocks and holding them for a long time. It's finding a strategy that works and sticking with it through the inevitable ups and downs of the market. If the strategy no longer recommends a particular stock after holding it for a month, the stock should be sold and replaced with a new stock that does meet your strategy's criteria. Adhering to a proven style over the long-term makes you a long-term investor -- even if you sometimes sell stocks in short-term time frames.

- **Diversify, But You Can't Beat the Market By Owning It**

Investors who hold too few stocks are taking an unnecessary amount of risk. On the other hand, mutual funds that own 500 stocks are inevitably going to closely track the returns of the market. Studies show that the benefits of diversification become limited after your portfolio increases beyond 50 stocks, and our experience is consistent with that.<sup>5</sup> Investors should thus hold a focused portfolio of 50 or less stocks, which provides most of the benefits of diversification, but also allows the winners in the portfolio to have a greater impact.

- **Size- and Style-Focused Systems are Just Limiting Investment Possibilities**

Good investments can be found in different market segments at different times. Why limit yourself to a particular style (such as small-cap growth stocks), when at any given time you may be able to find better opportunities in other areas of the market. The Hot List thus buys the most attractive stocks in the market, regardless of the size or style classification they represent.

## **A Sensible, Rational Approach To Investing**

More than three decades ago, Benjamin Graham -- who you might say was the first ever stock market guru - offered this advice to investors: "The individual investor should act consistently as an investor and not as a speculator. This means ... that he should be able to justify every purchase he makes and each price he pays by impersonal, objective reasoning that satisfies him that he is getting more than his money's worth for his purchase."<sup>6</sup>

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<sup>4</sup> "Our Interview With Mark Hulbert". *Advisor Perspectives*. April 1, 2008.

<sup>5</sup> Hsu, H. Christine, and Wei, H. Jeffrey. "Stock Diversification in The U.S. Equity Market". *Business Quest*, 2003.

<sup>6</sup> "A Conversation With Benjamin Graham." *Financial Analysts Journal*, September/October 1976.

More than 30 years later, Graham's words still ring true. The stock market is no place for hunch-playing or risky bets. You've worked hard to earn your money; why should you gamble it away by using methods that have short -- or no -- track records of success?

In the end, that is the edge the Validea Hot List offers -- an investing system based on strategies that do, in fact, have lengthy track records of beating the market over the long term. It is a system that values rational thinking and unemotional decision-making, and which is driven by data and decades of results -- exceedingly rare qualities in today's world of minute-to-minute financial news and knee-jerk trading.

Successful stock investing is about common sense, discipline, and the ability to see the forest while hordes of other investors focus only on individual tree after individual tree. That sort of mindset is why people like Warren Buffett, Benjamin Graham, Martin Zweig, and David Dreman have had such great success over the years -- and the failure to adopt such a mindset is why the vast majority of professional and individual investors have failed.

If you're tired of the same old below-average returns from your investment advisors (or yourself), and you're looking for a better long-term approach to investing, you have indeed come to the right place. The Hot List will offer you a wealth of information, both in terms of raw data and broader advice, all of which will give you the ability to stay ahead of both the broader market and other investors.

If you have further questions about the Hot List, see the "Frequently Asked Questions" and responses below, or feel free to contact me directly.

Best Regards,



John Reese

*Founder and CEO, Validea.com*

*Editor, Validea Hot List*

## Validea Hot List FAQ

### What is the Validea Hot List?

At Validea.com, we have always believed that the best way to beat the S&P 500 over the long-term is to learn from those who have consistently done so. That is why we developed automated strategies based on our interpretation of the published methodologies of some of history's best investors, including Peter Lynch, Ben Graham, Martin Zweig, Ken Fisher, David Dreman, and James O'Shaughnessy. The Validea Hot List model portfolio is based on a

proprietary system we have developed that combines all of these strategies. The newsletter is published every two weeks on Friday morning and the model portfolio is rebalanced every 28 days.

### **How do the Hot List rebalancings work?**

Each time we update the Hot List model portfolio, we perform a simulated transaction in which we sell the 10 stocks that were previously in the portfolio and then buy the 10 new stocks that currently meet the criteria of the model portfolio. By performing the updates to the portfolio using this method, we are able to not only get the new stocks in and the old stocks out, but also to ensure that the 10 stocks are equally weighted on each update date.

### **When did you begin tracking the Hot List performance?**

We started tracking performance on July 15th, 2003.

### **Do you invest money in the Hot List?**

No, the Hot List is a virtual portfolio. Our return calculation system calculates the returns as if an investor had followed our system, but Validea is not a money management firm and so all investment transactions are simulated. Employees of Validea may have positions in the stocks within the newsletter at the time of publication.

### **One of the stocks in the portfolio has experienced a large price increase or decrease since the last rebalancing. What do I do?**

Since Validea is not an investment advisor, we cannot give advice to holders of any securities published in our portfolio. The Hot List is rebalanced monthly and no changes are made to the portfolio in between these monthly rebalancings. The performance numbers published by Validea are based on holding all 10 stocks in the portfolio until the next rebalancing, regardless of how much the price changes in that period.

### **What are the tax consequences of following the Validea Hot List?**

We recommend consultation with your tax professional before following the Validea Hot List. Because we change the portfolio monthly and it can have high turnover, following the strategy may result in gains being taxed higher short-term rates. Since we cannot know your personal tax situation, we recommend you consult with a professional before following our portfolio.

### **Is there any affiliation between Validea and the creators of the underlying guru strategies the Hot List is based on?**

No, the names of individual investment advisors (i.e., the 'gurus') appearing on our site are for identification purposes of his methodology only, as derived by Validea.com from published sources, and are not intended to suggest or imply any affiliation with or endorsement or even agreement with our reports personally by such gurus, or any knowledge or approval by such persons of the content of our site.