

# Modeling the Strategies of Buffett, Graham and Other Investing Greats

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# Goal of today's presentation

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Share with you the fundamental stock selection strategies of two legendary value investors – Ben Graham and Warren Buffett. In total, we run 22 unique models, 12 of them are available publicly on Validea.com

Share with you 5 Keys to Success that I have learned in my investing career and in running systematic models.

Look at some of the tools on Validea.com, our research site that utilizes these models in real-time stock analysis, model portfolios, screeners and more.



**John Reese**

# My Story...

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MIT/Harvard Business School– Experience at MIT’s Artificial Intelligence Lab set the stage.

Built a successful technology business and sold to GE Capital. Looking for ways to invest and began an extensive research project (mid 90s)

Founded Validea.com in late 90s. Granted two patents in the area of automated stock analysis.

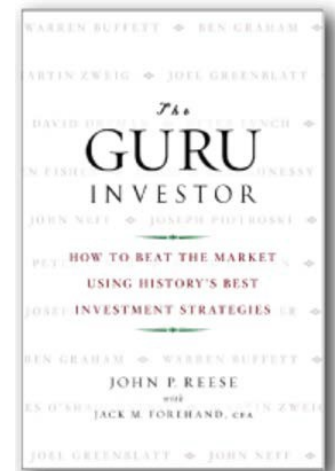
Breakthrough was the model portfolios that were developed in 2003.

Has written two books on guru strategies and systematic based investing – The Guru Investor (2009) & The Market Gurus (2001).

Founded Validea Capital in 2004 to help manage clients’ money in this investing system.

In 2007, Validea Capital was hired by National Bank of Canada to sub-advise two mutual funds.

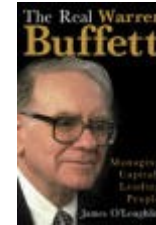
Manage over \$650 million in my guru-based portfolios.



# At Validea we follow numerous guru strategies, including:

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



# Why these “Gurus”? Three Key Reasons

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- 1) Each has a long term record of outperforming the market
- 2) Publicly disclosed these techniques either in books, academic papers or other sources
- 3) Created a quantitative methodology that can be leveraged using a computer program

Let's look at the  
quantitative  
strategy of:

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BEN GRAHAM

# Ben Graham – The “Granddaddy” of the Gurus

## STEP 1 – Sector & Sales Limis

1. All stocks (including public utilities) besides technology firms **Pass**. Technology stocks **Fail**
2.  $\geq$  \$340 million **Pass**
3.  $<$  \$340 million **Fail**

## STEP 2 – Current Ratio

1. Current ratio  $\geq$  2 **Pass**
2. Current ratio  $<$  2, and company is a utility or telecom **Pass**
3. Current ratio  $<$  2, and company is not utility or telecom **Fail**

## Methodology Example, Ben Graham

### STEP 3 – LT Debt in rel. to Net Cur. Assets

1. Long-term debt  $\leq$  Net current assets **Pass**
2. Long-term debt  $>$  Net current assets **Fail**

### STEP 4 – Long Term EPS Growth

1.  $\geq 30\%$ , and no negative annual EPS in last five years  
**Pass**
2.  $< 30\%$  **Fail**
3.  $\geq 30\%$ , with negative annual EPS in any of last five years  
**Fail**



# Methodology Example, Ben Graham

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## STEP 5 – Price-Earnings Ratio

1.  $P/E \leq 15$  **Pass**
2.  $P/E > 15$  **Fail**

## STEP 6 – Price-Book Ratio

1.  $P/B \times P/E \leq 22$  **Pass**
2.  $P/B \times P/E > 22$  **Fail**

# Methodology Example, Ben Graham

## STEP 7 – Total Debt-Equity Ratio

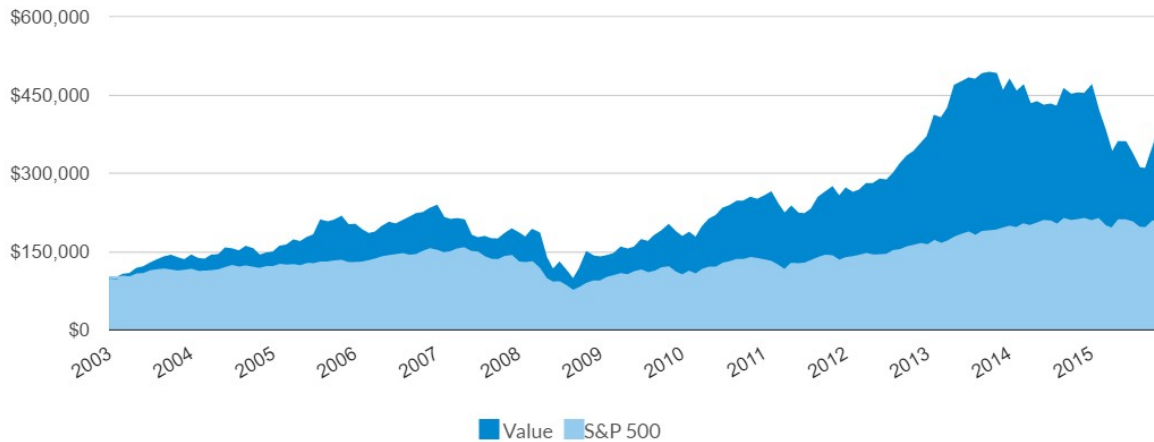
1. Industrial companies— $D/E \leq 100\%$  **Pass**
2. Utilities, phone companies, railroads— $LTD/E \leq 230\%$   
**Pass**
3. Industrial companies— $D/E > 100\%$  **Fail**
4. Utilities, phone companies, railroads— $LTD/E > 230\%$  **Fail**

# Graham / Value Investor Model Portfolio in Real-Time

## Value Investor

Based on the book by Benjamin Graham

Since 2003, this portfolio has returned **269.8%**, outperforming the market by **163.5%** using its optimal **annual** rebalancing period and **10 stock** portfolio size.



Annual Return:	10.7%
S&P 500:	5.8%

Year To Date:	10.6%
S&P 500:	1.0%

Beta:	1.13
Accuracy:	59.2%

[www.validea.com/value-investor-portfolio/benjamin-graham](http://www.validea.com/value-investor-portfolio/benjamin-graham)

# Graham / Value Investor Top Scoring Stocks

## Current Top Rated Stocks

The stocks that would be in this portfolio if it were rebalanced today.

TICKER	COMPANY	CURRENT SCORE	LATEST CLOSE	MARKET CAP (\$MIL)	PE RATIO	EPS GROWTH	YIELD	RELATIVE STRENGT...
UNFI	UNITED NATURAL FOODS, INC.	100%	\$34.26	\$1,724	13.2	13.5%	N/A	25
FOSL	FOSSIL GROUP INC	100%	\$41.18	\$1,982	9.1	-1.0%	N/A	23
WLK	WESTLAKE CHEMICAL CORPORATION	100%	\$48.95	\$6,378	10.1	22.8%	1.5%	34
DDS	DILLARD'S, INC.	100%	\$70.61	\$2,515	10.2	5.6%	0.4%	26
SSL	SASOL LIMITED (ADR)	100%	\$29.96	\$19,566	14.9	10.5%	4.1%	42
UTHR	UNITED THERAPEUTICS CORPORATION	86%	\$110.55	\$4,925	6.1	37.8%	N/A	34
FSS	FEDERAL SIGNAL CORPORATION	86%	\$12.26	\$765	11.8	46.2%	2.3%	46
WDR	WADDELL & REED FINANCIAL, INC.	86%	\$19.64	\$1,600	7.6	9.9%	9.4%	19
TECD	TECH DATA CORP	86%	\$63.62	\$2,234	8.6	14.6%	N/A	75
BRCD	BROCADE COMMUNICATIONS SYSTEMS, INC.	86%	\$8.25	\$3,309	10.1	39.6%	2.2%	38

Let's look at the  
quantitative  
strategy of:

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WARREN BUFFETT

# Warren Buffett – The “Greatest” Guru

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## **STEP 1 – Buffett Type Company?**

1. Nature of firm’s business?
2. Ability to pass on costs?
3. Complexity of product / business model?

*Note: this is qualitative analysis vs. quantitative.*

# Methodology Example, Warren Buffett

## STEP 2 – Earning Predictability

1.  $Y1 \geq Y2 \geq Y3 \geq Y4 \geq Y5 \geq Y6 \geq Y7 \geq Y8 \geq Y9 \geq Y10$   
(No years with a negative EPS.) **Pass-Best Case**
2.  $Y1 \geq Y2 \geq Y3 \geq Y4 \geq Y5 \geq Y6 \geq Y7 \geq Y8 \geq Y9 \geq Y10$   
(except for dips from a prior year's earnings, that total no more than 45 percent). No years with a negative EPS. **Pass**
3. All other combinations **Fail**

# Methodology Example, Warren Buffett

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## STEP 3 – Long Term Debt

1.  $\leq 2$  times earnings **Pass – Best case**
2.  $> 2$  and  $\leq 5$  times earnings **Pass**
3.  $> 5$  times earnings **Fail**

## STEP 4 – Return on Equity

1.  $\geq 15\%$  **Pass**
2.  $< 15\%$  **Fail**

## STEP 5 – Return on Capital

1.  $\geq 12\%$  **Pass**
2.  $< 12\%$  **Fail**



# Methodology Example, Warren Buffett

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## STEP 6 – Capital Expenditures

1.  $> 0$  **Pass**
2.  $\leq 0$  **Fail**

## STEP 7 – Utilization of Retained Earnings

1.  $\geq 15\%$  **Pass—Best case**
2.  $\geq 12\%$  and  $< 15\%$  **Pass**
3.  $< 12\%$  **Fail**

# Methodology Example, Warren Buffett

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## IS THE PRICE RIGHT?

### STEPS 8-15 – Calculate Expected Return

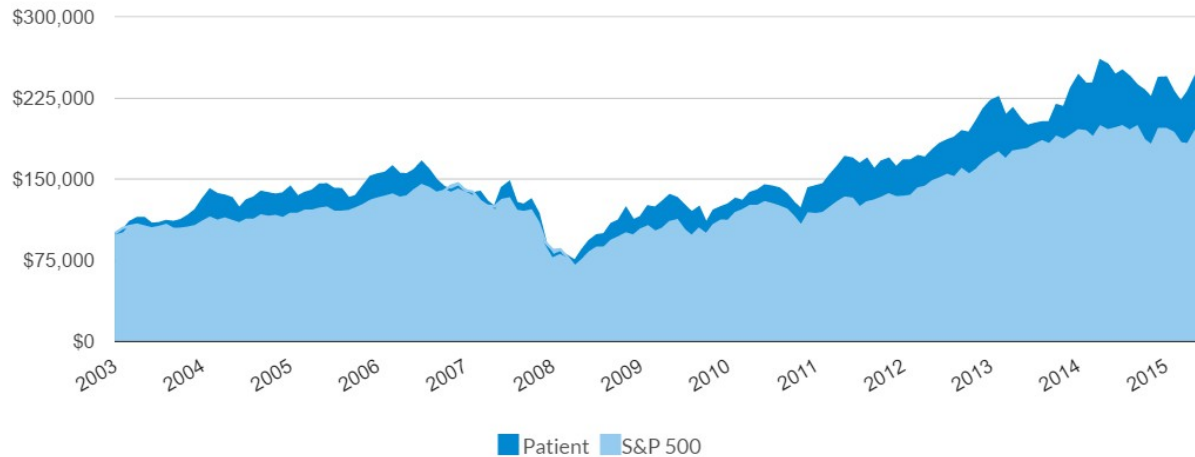
1. Calculate expected return w/ROE method.
2. Calculate expected return w/EPS method.
3. Take the average of the ROE and EPS methods to determine if return is in the acceptable range (**likes to see 15%**).

# Buffett / Patient Investor Model Portfolio in Real-Time

## Patient Investor

Based on the book by Warren Buffett

Since 2003, this portfolio has returned **136.9%**, outperforming the market by **42.6%** using its optimal **monthly** rebalancing period and **10 stock** portfolio size.



This strategy seeks out firms with long-term, predictable profitability and low debt that trade at reasonable valuations.

Annual Return:  
S&P 500:

**7.2%**  
**5.5%**

Year To Date:  
S&P 500:

**2.7%**  
**1.0%**

Beta:  
Accuracy:

**1.04**  
**56.2%**

<http://www.validea.com/patient-investor-portfolio/warren-buffett>

# Buffett / Patient Investor Top Scoring Stocks

## Current Top Rated Stocks

The stocks that would be in this portfolio if it were rebalanced today.

TICKER	COMPANY	CURRENT SCORE	LATEST CLOSE	MARKET CAP (\$MIL)	PE RATIO	EPS GROWTH	YIELD	RELATIVE STRENGTH...
WRLD	WORLD ACCEPTANCE CORP.	100%	\$43.49	\$388	3.6	21.3%	N/A	23
AAPL	APPLE INC.	100%	\$95.18	\$521,341	10.6	23.5%	2.4%	40
CACC	CREDIT ACCEPTANCE CORP.	100%	\$184.93	\$3,759	12.8	19.3%	N/A	47
FDS	FACTSET RESEARCH SYSTEMS INC.	100%	\$148.78	\$6,082	24.8	12.1%	1.2%	58
ROST	ROSS STORES, INC.	100%	\$57.30	\$23,023	22.8	14.7%	0.9%	81
TJX	TJX COMPANIES INC	100%	\$77.03	\$51,021	23.1	13.0%	1.4%	83
CTSH	COGNIZANT TECHNOLOGY SOLUTIONS CORP	99%	\$57.65	\$34,929	21.8	16.5%	N/A	57
BIDU	BAIDU INC (ADR)	99%	\$174.36	\$60,372	18.3	43.6%	N/A	51
SYNT	SYNTEL, INC.	99%	\$41.80	\$3,509	13.3	15.7%	N/A	57
BMA	BANCO MACRO SA (ADR)	93%	\$61.66	\$3,701	10.1	44.0%	0.4%	79

Do these Guru  
Strategies still  
work today?

**YES**

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But First...

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- ▶ Running these guru-models in real-time since 2003
- ▶ Ok, let's see the results.

# Guru Portfolios – Optimal # of Stocks + Optimal Rebalancing

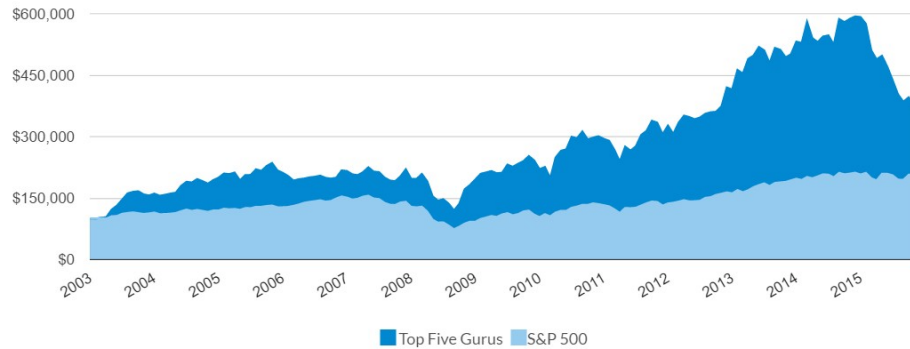
Guru Based on	Portfolio	Number Of Stocks	Rebalancing	Inception Date	Return	S&P 500	+/- S&P 500	Beta
Motley Fool	Small-Cap Growth Investor	10	Monthly	7/15/2003	440.9%	106.3%	^ 334.6%	1.14
Peter Lynch	P/E/Growth Investor	20	Monthly	7/15/2003	310.8%	106.3%	^ 204.5%	1.15
Martin Zweig	Growth Investor	20	Quarterly	7/15/2003	280.6%	106.3%	^ 174.3%	1.10
Benjamin Graham	Value Investor	10	Annual	7/15/2003	269.8%	106.3%	^ 163.5%	1.13
Kenneth Fisher	Price/Sales Investor	10	Monthly	7/15/2003	258.3%	106.3%	^ 152.0%	1.16
Validea	Momentum Investor	20	Quarterly	7/15/2003	245.3%	106.3%	^ 139.0%	0.98
James O'Shaughnessy	Growth/Value Investor	20	Quarterly	7/15/2003	155.3%	106.3%	^ 49.0%	0.99
Warren Buffett	Patient Investor	10	Monthly	12/5/2003	136.9%	94.4%	^ 42.5%	1.04
Joseph Piotroski	Book/Market Investor	20	Annual	2/27/2004	126.3%	80.0%	^ 46.3%	1.08
Joel Greenblatt	Earnings Yield Investor	10	Quarterly	1/27/2006	98.7%	62.0%	^ 36.7%	1.04
John Neff	Low PE Investor	20	Quarterly	1/2/2004	79.2%	85.6%	▼ -6.4%	1.16
David Dreman	Contrarian Investor	20	Monthly	7/15/2003	63.2%	106.3%	▼ -43.1%	1.19

# Consensus Models – Blending Guru Strategies to Help With Strategy Risk

## Top Five Gurus

Combines 5 top performing models

Since 2003, this portfolio has returned **262.9%**, outperforming the market by **156.7%** using its optimal monthly rebalancing period and 10 stock portfolio size.

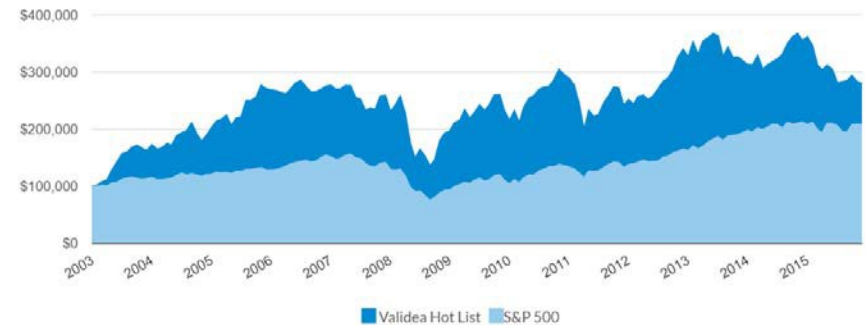


Annual Return:	10.6%
S&P 500:	5.8%
Year To Date:	-17.0%
S&P 500:	1.0%
Beta:	1.08
Accuracy:	55.2%

## Validea Hot List

Looks for Consensus among top performing models

Since 2003, this portfolio has returned **180.2%**, outperforming the market by **73.9%** using its optimal monthly rebalancing period and 10 stock portfolio size.



Annual Return:	8.4%
S&P 500:	5.8%
Year To Date:	-0.6%
S&P 500:	1.0%
Beta:	1.18
Accuracy:	53.8%



# Validea's 5 Keys to Successful Investing

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# Validea's 5 Keys to Successful Investing

## **1. Think Long Term**

# Always, Always Think Long Term

The market is very risky and uncertain in the short term. 50% declines 4 times throughout history.

The odds are in your favor if you take a long-term view.

Even a 65 year old today has to make his/her money grow for another 20 -25 years.

Unless you are a trader, taking the long view is the best approach.

# Validea's 5 Keys to Successful Investing

1. Think Long Term

**2. Be Unemotional & Disciplined**

# Emotions Hurt Performance...

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## Emotions & Biases cost investors 4% per year on average

- Over the last 20 years the S&P 500 has returned 9.2% compared to 5% for all investors (DALBAR study)

## Behavioral Biases that lead to that underperformance:

- **Overoptimism:** Being overly optimistic in our estimate of our abilities to find good stocks and produce market-beating returns
- **Overconfidence:** Overconfident that our judgment is always right, which creates an illusion of control and knowledge
- **Recency Bias:** People's tendency to give too much credence to their most recent, short-term experience
- **Loss Aversion:** Fear of losing money and subsequent inability to withstand short-term events and maintain a long-term perspective

## Validea's 5 Keys to Successful Investing

1. Think Long Term
2. Be Unemotional & Disciplined
- 3. Know Your “True” Risk Tolerance**

# Understanding Market Volatility and your own Risk Tolerance

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- All good stock strategies can experience large declines and all highly active strategies can underperform;
- The loss is not permanent unless you sell out;
- If you can't handle a +40% decline, you shouldn't be fully invested in stocks.

# Need to Adapt the Right Mindset to Overcome

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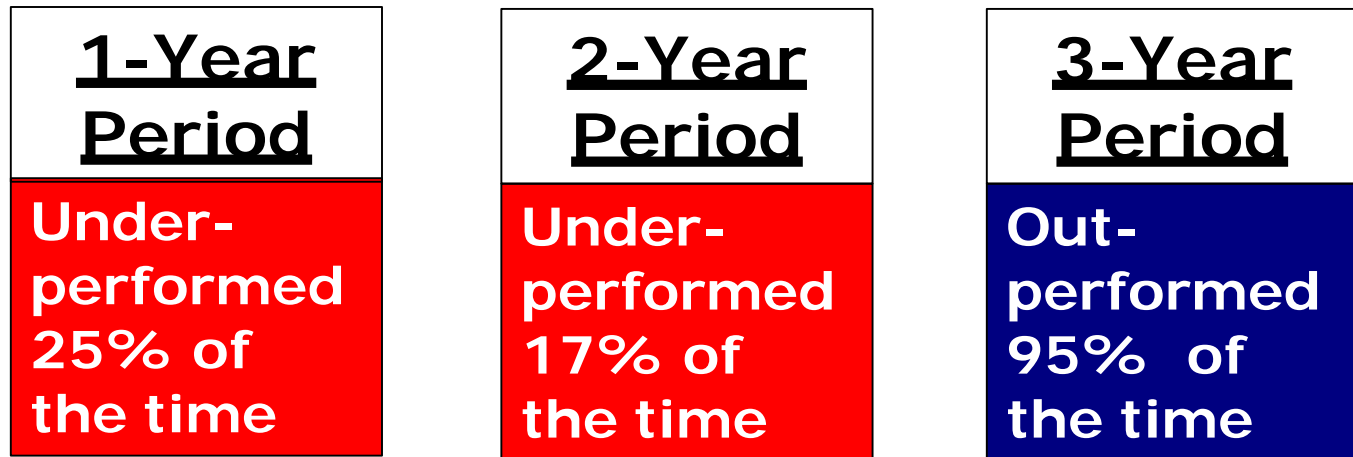
- Stocks recover losses relatively quickly (*stocks took 22 months to recover all losses once the market bottomed in March of 2009*);
- Make sure you are taking advantage of the only “free lunch” in investing – diversification;
- Downside volatility can be your friend if you are adding to your portfolio as corrections and bear markets allow you to buy stocks on the cheap.



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

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Seminal Study by Joel Greenblatt in “The Little Book That Beats the Market”. Greenblatt is the founder of Gotham Capital. He examined how often his very successful strategy underperformed the market for various periods.



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

## Validea's 5 Keys to Successful Investing

1. Think Long Term
2. Be Unemotional & Disciplined
3. Know Your “True” Risk Tolerance
- 4. Stick to the Fundamentals**

# Stick to the Fundamentals

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## **Great Investors Invest Based on Fundamentals**

- None of the great investors with long term records are technical investors.

## **Avoid investing based on the current headlines**

- David Dreman study of 11 major post-WWII crises found that market was up on average by 25.8% a year after the crisis
- Following the Sept. 11, 2001 terrorist attacks, it took just one month for the S&P 500 to climb back to pre-Sept. 11 levels.
- Kenneth Fisher study: Only once in history has a war/conflict stopped a bull market (1938)
- Tetlock Study on analyzing the accuracy of experts (studied over 80,000 predictions).

## Validea's 5 Keys to Successful Investing

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1. Think Long Term
2. Be Unemotional & Disciplined
3. Stick to the Fundamentals
4. Know Your “True” Risk Tolerance
- 5. Understand the Strategy & Have Conviction**

# Understand the Strategy & Have Conviction

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The more you understand a strategy, the better off you will be.

You will be able to understand the good and bad periods of performance, and also have the confidence to stick with a good long-term strategy through rough short-term stretches.

## Buffett Quote on Emotions & Discipline

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

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

**Warren Buffett**, Chairman Berkshire Hathaway

# Research Tools on Validea.com

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## Guru Analysis

Validea's Guru Analysis offers a step by step analysis of any stock using our interpretation of the strategies of Wall Street Legends like Warren Buffett, Peter Lynch and Benjamin Graham.

<http://www.validea.com/guru-analysis>

## Model Portfolios

We've developed portfolios based on the investment strategies of history's most successful stock pickers

<http://www.validea.com/portfolios>

## Guru Stock Screener

Screen for stocks passing the proven strategies of Wall Street Legends like Warren Buffett, Peter Lynch and Benjamin Graham.

<http://www.validea.com/guru-stock-screener>