

# VALENS RESEARCH



## How to Beat the Market

Joel Litman  
January 2017

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# How to beat the market

Understand the market's valuation and what drives it

“Embedded Expectations”

“The first duty of the investor or analyst is to figure out what is embedded in the price, what is discounted.”

“The failure to address that question is the main source of the poor relative results of most money managers and the general lack of value provided by the opinions of analysts.”

- Bill Miller



Stock-picking is like poker...

“Poker, of all games, is most like stock investing.” Peter Lynch

“To be safe and cheap, you have to turn down a lot of ideas also.  
So you would miss a lot of good stuff that is a little pricy.”  
Whitman

“...it's a matter of "patience and discipline -- you need them in  
both investing and poker." John Rogers (Founder, Ariel Capital)

“You have to look for the market’s tells... when fundamentals  
change... and prices don’t” Bill Gross

It's not about what you think.

It starts with what you think the market thinks.

What you may have learned previously is backwards.

## How to beat the market

Understand the market's valuation and what drives it

“Embedded Expectations”

Know the market is going to change its mind

“Mispricing”

Are the markets efficient?

“I'd be a bum on the street with a tin cup  
if the markets were efficient.”

-- Buffett

“If only one word is to be used to describe what Baupost does, that word should be: ‘Mispricing’.”

-- Seth Klarman





“We try to find things that are misunderstood.

And then if we think something is misunderstood  
then we figure out if it’s misvalued.

And if we figure out that it’s misunderstood and misvalued,  
then we tend to invest. ”

-- David Einhorn, Greenlight Capital



“...made a fortune out of buying  
and selling the mundane,  
the unwanted, and the unglamorous.”

-- Washington Post on Farley

“We like positive surprises  
and upward earnings revisions  
and bigger than expected gains.”

-- Richard Driehaus

“...share a significant trait...

...We are looking for what we believe are terrific stocks trading for less than our estimate of the company's worth as a business.”

-- Chuck Royce



## How to beat the market

Understand the market's valuation and what drives it

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Know the market is going to change its mind

“Mispricing”

Make a position *reasonably prior* to the market doing that

“Catalyst”



“The graveyards of Wall Street  
are filled with people  
who were right too soon.”

-- William Peter Hamilton



“There is nothing so disastrous as a rational investment policy in an irrational world.”

-- John Maynard Keynes



“Markets can remain irrational a lot longer than you and I can remain solvent.”

-- A. Gary Shilling

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Analytical Advantage

Emotional Advantage

Informational Advantage



Warren Buffett, Berkshire Hathaway, 21.4% annualized since 1965  
Seth Klarman, The Baupost Group, 20% since 1983  
Jim Simons, Berlekamp, Renaissance Capital, 38.5% 1999 to 2006  
Bill Miller, Legg Mason, 15.25% annual returns, held 15 year streak  
Arnold Van Den Berg, Century Management, 16.62% since 1974  
Martin Whitman, Third Avenue Value Fund, 16.83% since 1990  
George Soros, Quantum Fund, 31% annual return 1969 to 2000  
Julian Robertson, Tiger Capital, appx. 25% over 25 years  
Chuck Royce, Royce Funds, Small Cap, 2000-10: 120+% vs. S&P  
Stephen A. Cohen, SAC, Trader, 40% annual returns since 1992  
Paul Tudor Jones, Tudor Asset Management, Trading Billionaire

Source- Investopedia, Money Times, Financial Times, gurufocus.com

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Fundamental: The story

Quantitative: “The Quants”

Technical: The charts

Fundamental: The story

Quantitative: “The Quants”

Technical: The charts

UAFRS:

Uniform Adjusted  
Financial Reporting  
Standards

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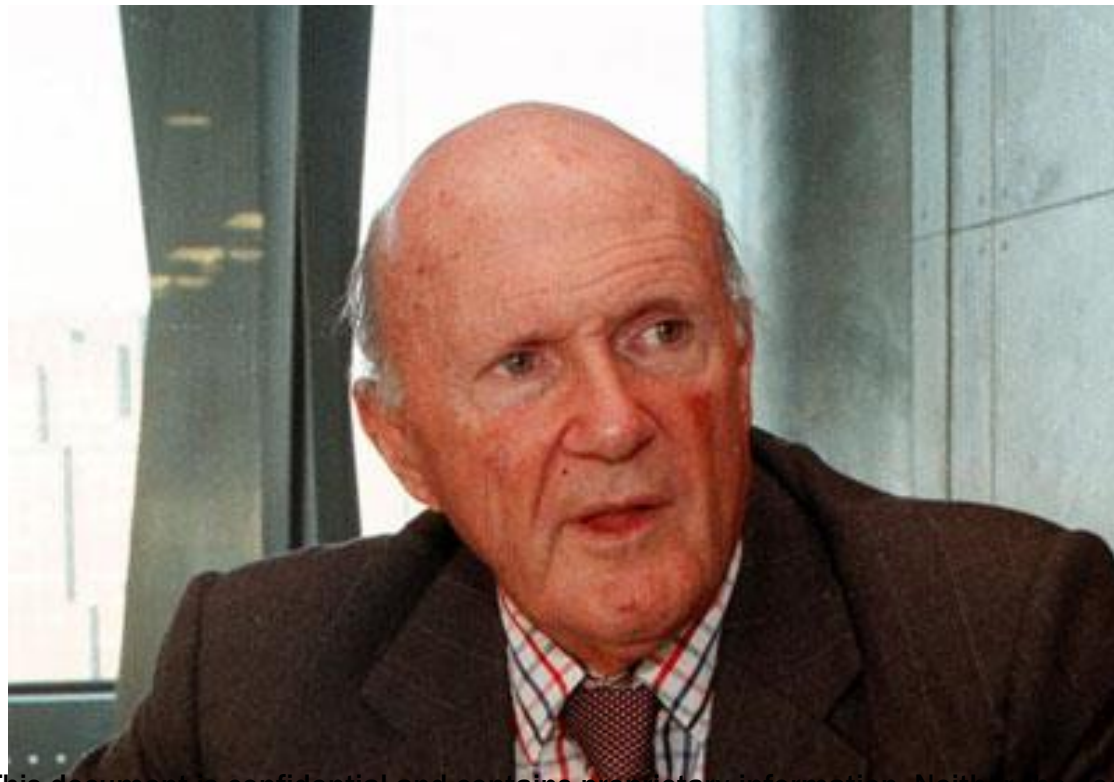
“Success in investing doesn't correlate with I.Q. once you're above the level of 25.

Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing.”

Buffett

“Be fearful when others are greedy, and greedy when others are fearful”

- Julian Robertson



“Regardless of the reason, some investors tend to get overly excited about stocks that have done very well in the past, buy them up, and these "glamour" stocks become overpriced.”

Van Den Berg



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“Most of the time common stocks are subject to irrational and excessive price fluctuations in both directions as the consequence of the ingrained tendency of most people to speculate or gamble... to give way to hope, fear and greed.”  
Graham



“We all have the tendency to be influenced by short-term events – and that tendency makes people stock market speculators.”

“It’s unnatural for humans to think totally different from the crowd.” Brandes

Charles Brandes



“You can continue to expect us to provide careful attention during periods of stock market craziness as we attempt to use the 'madness of crowds' to our advantage.”

Chuck Royce

“When the herd is single-mindedly focused... prices are frequently bid up and returns driven down.”

Seth Klarman

# Market Phase Cycle™

 INSTITUTE OF STRATEGY & VALUATION



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Understand the market's valuation and what drives it

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Know the market is going to change its mind

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Make a position *reasonably prior* to the market doing that

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# Investigative Investing

Primary Research

Get out of the office  
or at least get on the phone



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# VALENS RESEARCH



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January 2017

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## Sector performance by business cycle phase

*Each phase of the business cycle has sectors that have tended to either lead or lag the broader market.*

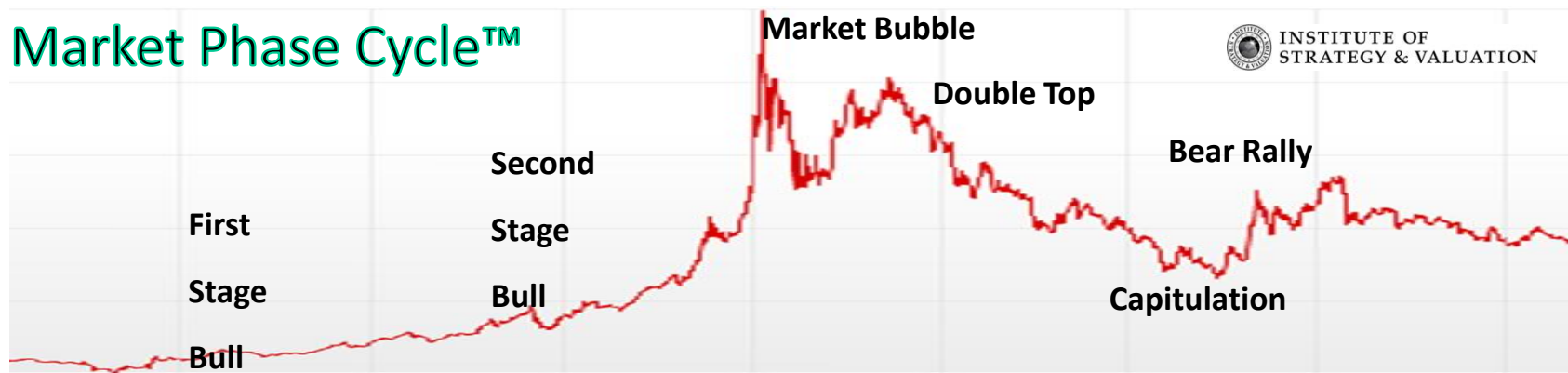


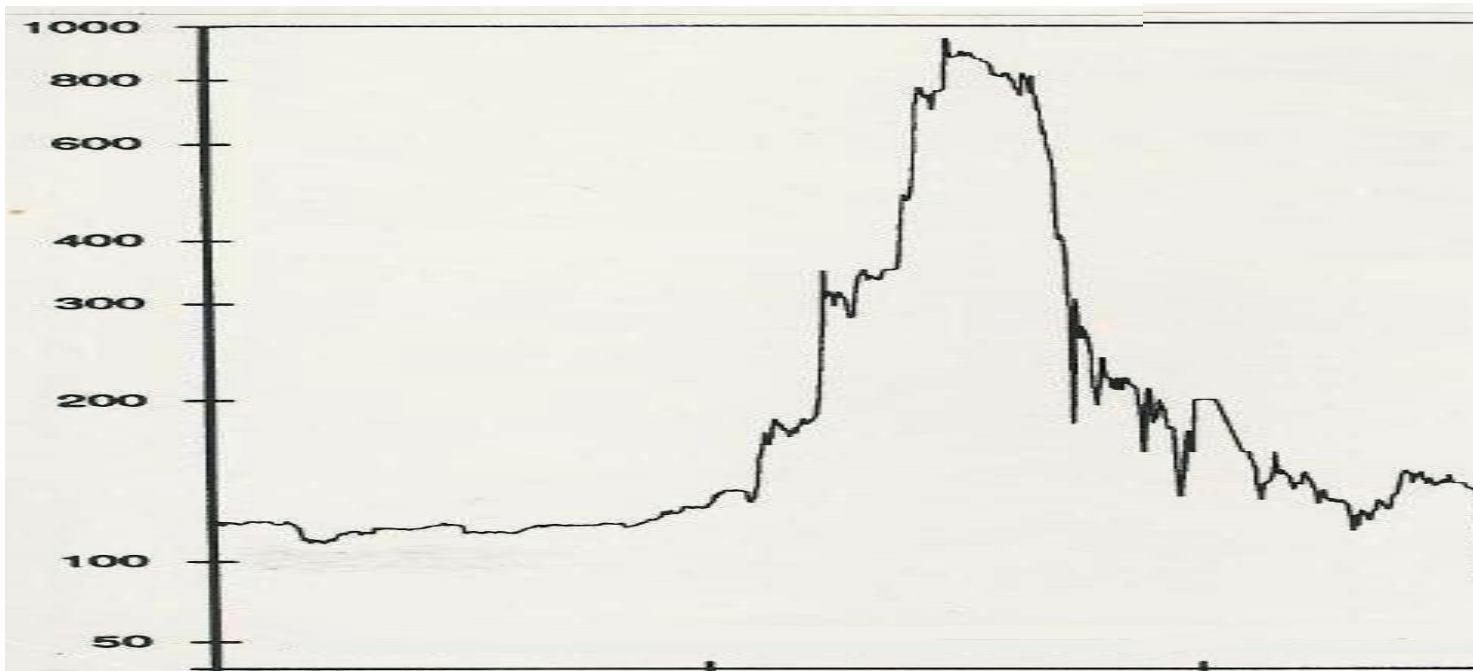
Source: Fidelity Investments (AART). Unshaded (blue) portions above suggest no clear pattern of over- or underperformance vs. broader market.

# Market Phase Cycle™



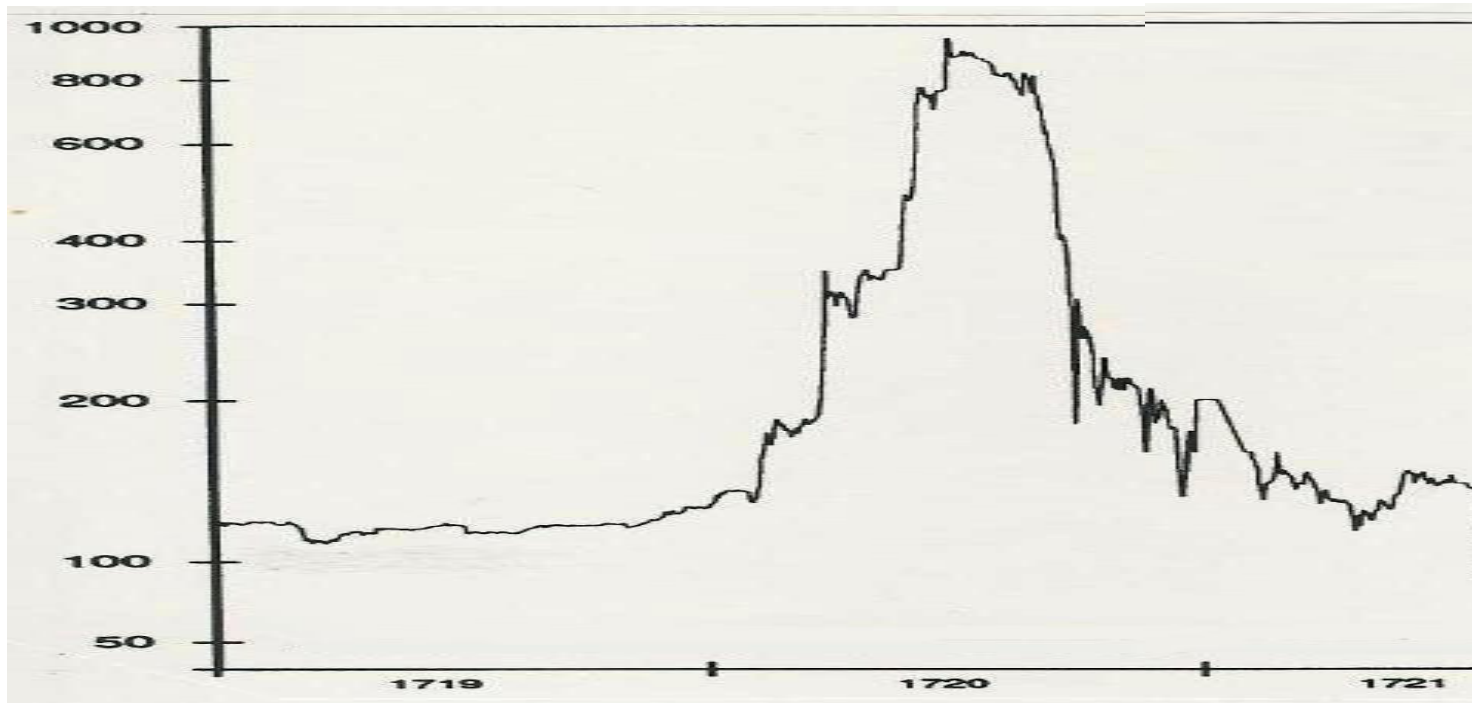
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STRATEGY & VALUATION





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# South Sea Bubble





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*"If the rating agencies will downgrade only when we can all see the losses, then why do we need the rating agencies?"*

-- Jim Chanos, Kynikos Associates



**VALENS**  
SECURITIES

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# How to beat the market

Understand the market's valuation

Know the market will change its mind

Make a position *just prior* to that











Analytical Advantage

Emotional Advantage

Informational Advantage

## Sector performance by business cycle phase

*Each phase of the business cycle has sectors that have tended to either lead or lag the broader market.*

Sector	Early	Mid	Late	Recession	Sector	Early	Mid	Late	Recession
Financials 	+				Cons Staples 			+	+
Cons Disc 	+		-	-	Health Care 			+	+
Technology 	+	+	-	-	Energy 	-		+	
Industrials 	+	+		-	Telecom 	-			+
Materials 	+	-	+		Utilities 	-	-	+	+

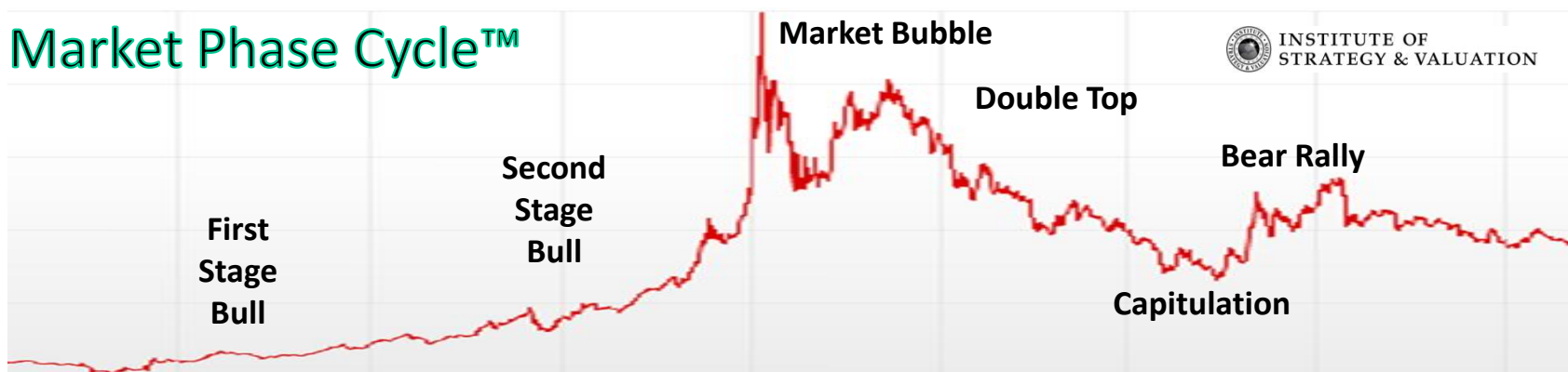
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## Market Phase Cycle™



- V, Q, M: 70+% M
- Earnings surprises
- Earnings revisions
- Upward guidance
- Improving ROI
- Increasing CAPX (or anything)

# Market Phase Cycle™

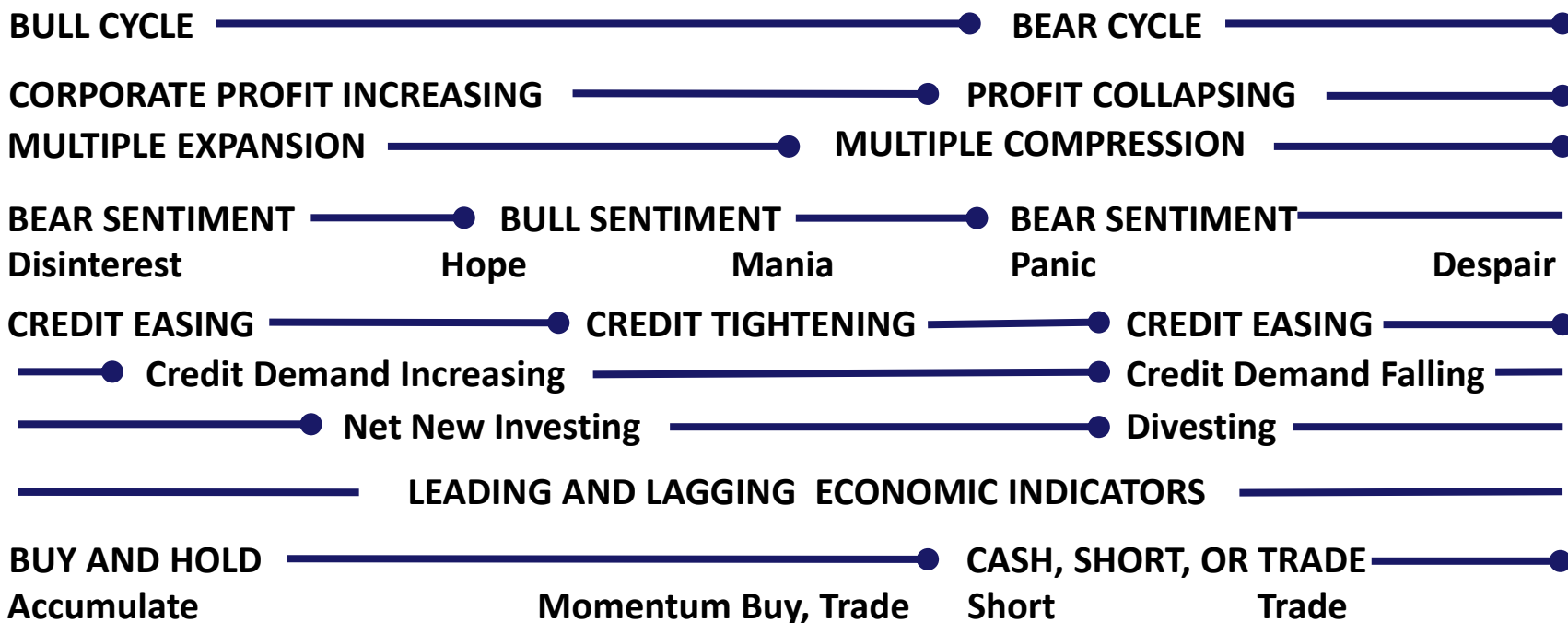
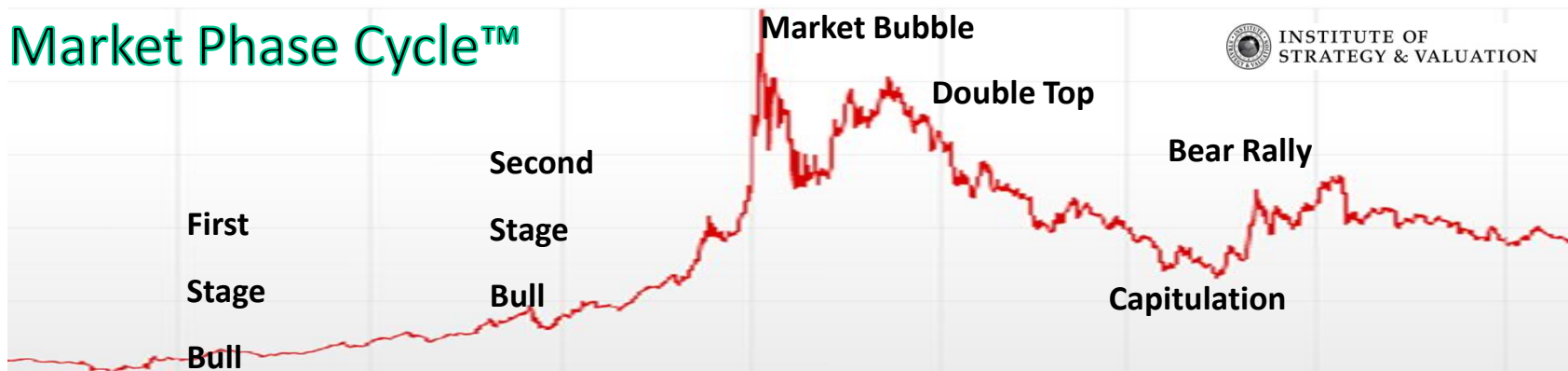


**BULL CYCLE**

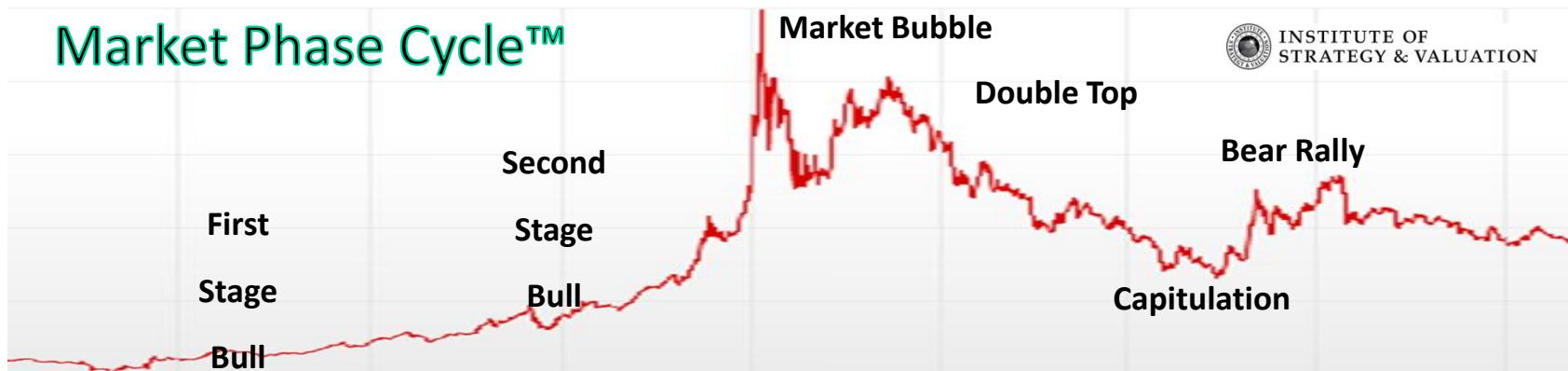
**BEAR CYCLE**

- V, Q, M: 70+% M
- Earnings surprises
- Earnings revisions
- Upward guidance
- Improving ROI
- Increasing CAPX

# Market Phase Cycle™



# Market Phase Cycle™



**BULL CYCLE**

**BEAR CYCLE**

“Be fearful when others are greedy, and greedy when others are fearful” Julian Robertson, The Tiger Funds

“Success in investing doesn't correlate with I.Q. once you're above the level of 25. Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing.” Buffett

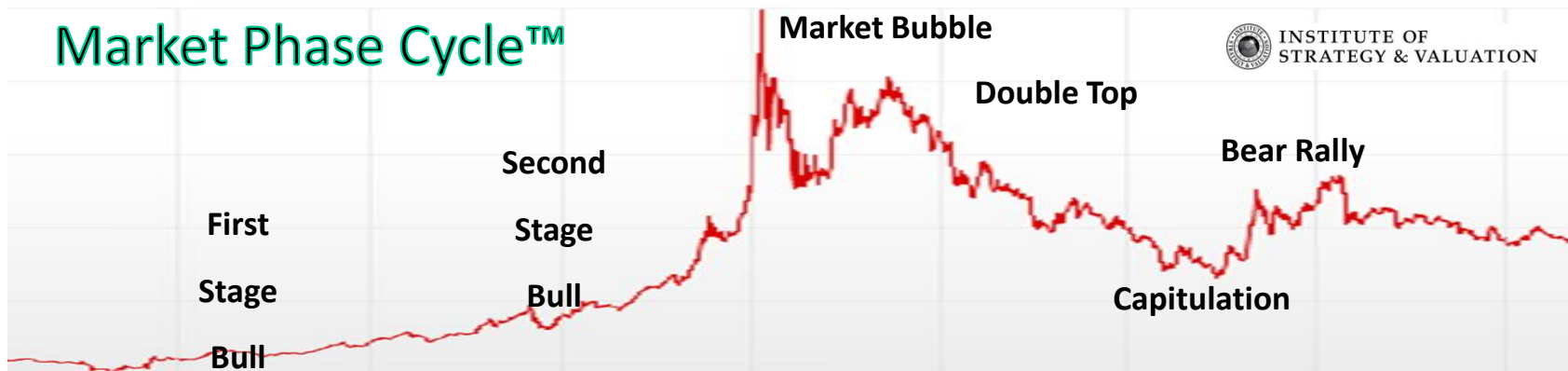
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“It's unnatural for humans to think totally different from the crowd.” Brandes



# Market Phase Cycle™



**BULL CYCLE**

**BEAR CYCLE**

# DJIA



# NASDAQ peaking in 2000

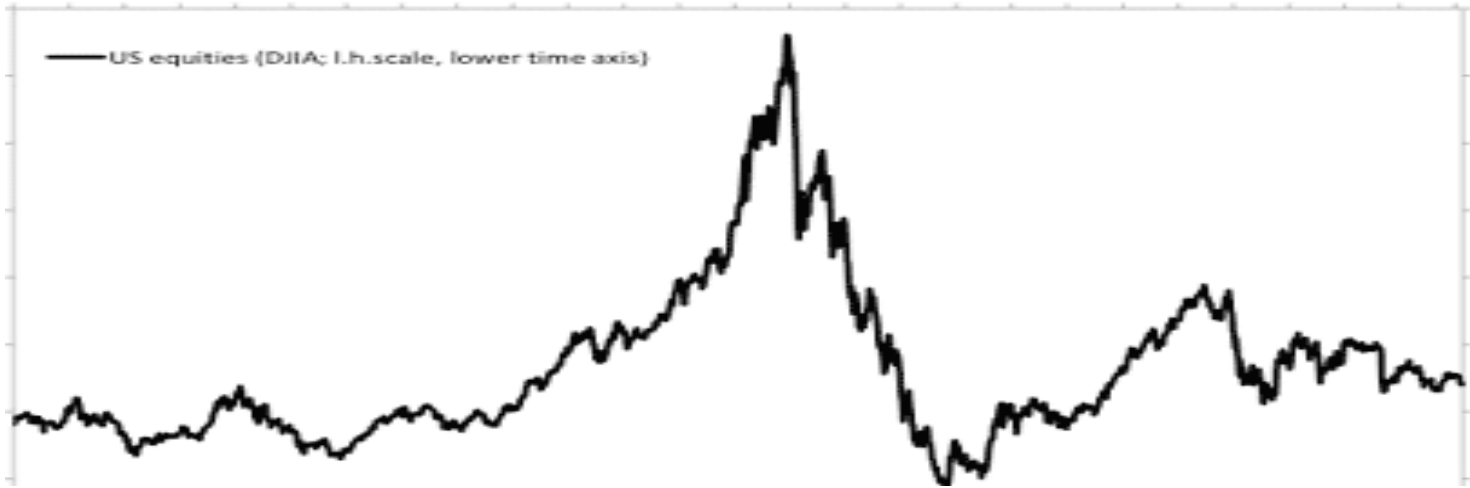


**DJIA (1920-1943)**

**NASDAQ (7/1990 - Present)**





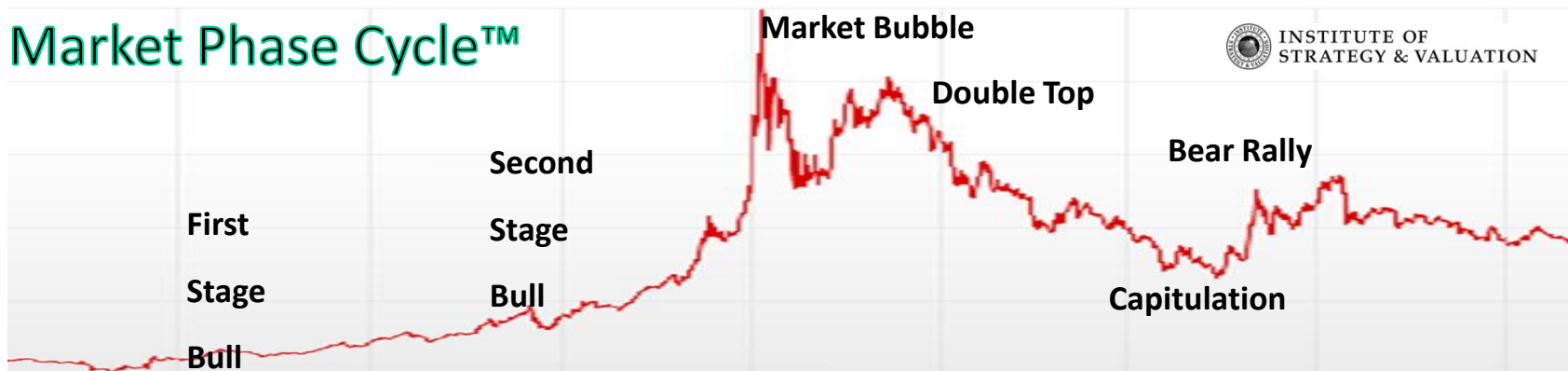


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# Market Phase Cycle™



**BULL CYCLE**

**BEAR CYCLE**

**CORPORATE PROFIT INCREASING**

**PROFIT COLLAPSING**

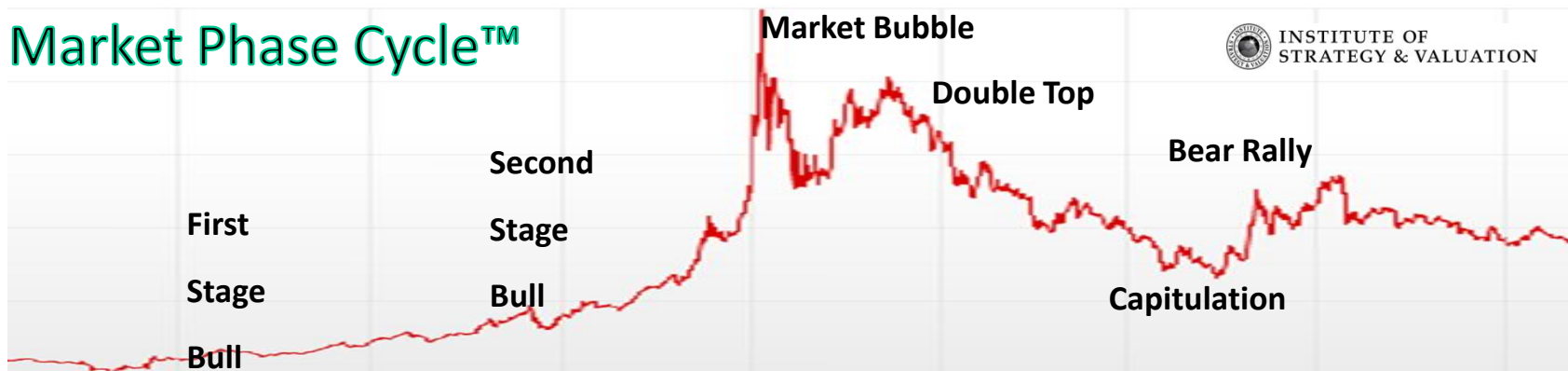


# Corporate Profitability and Valuation

Earnings (Adjusted for Accounting Distortions)

Assets (Adjusted For Accounting Distortions)

# Market Phase Cycle™



# Corporate Profitability and Valuation

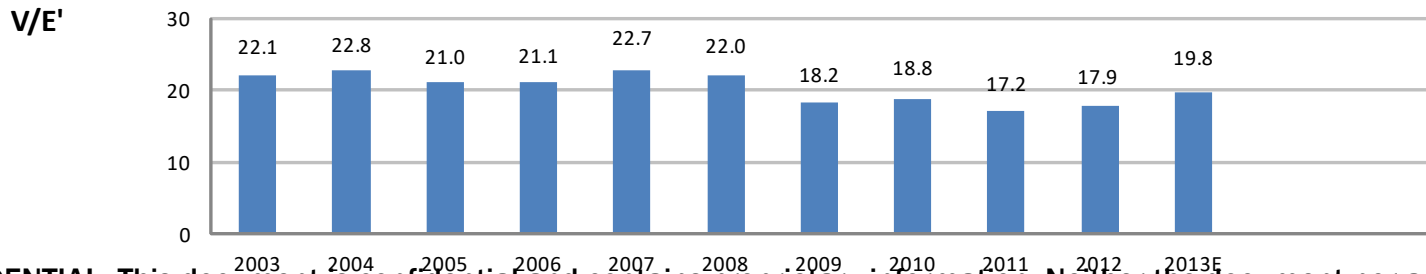
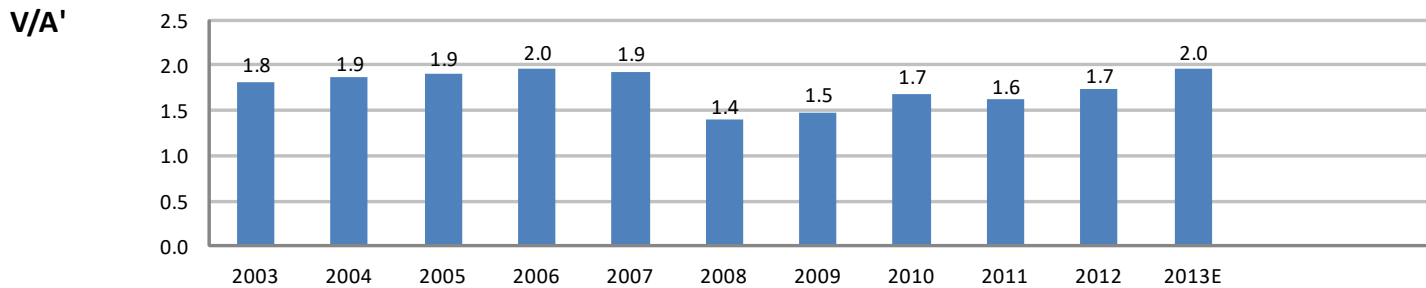
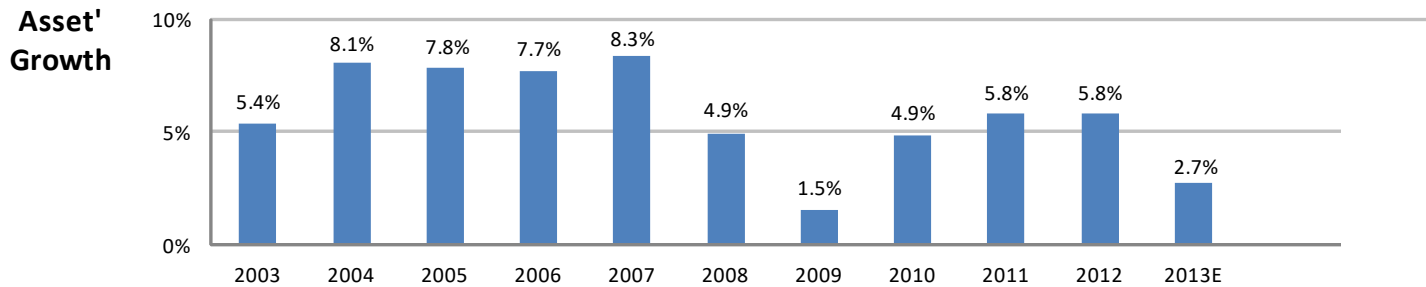
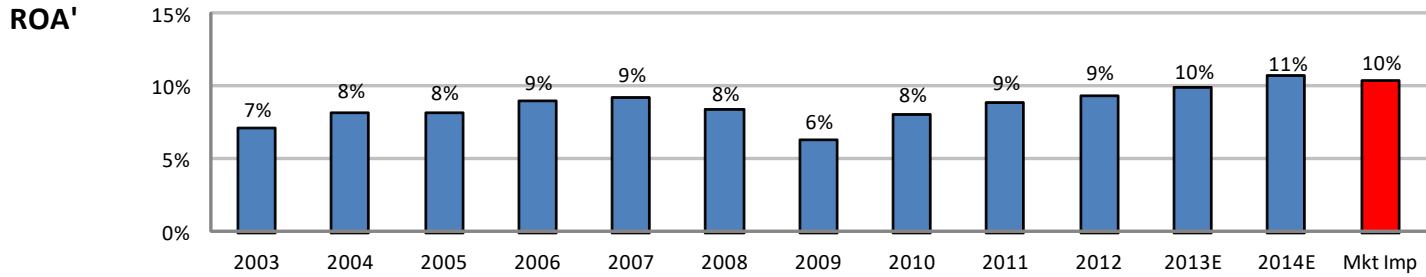
Earnings (Adjusted for Accounting Distortions)

Assets (Adjusted For Accounting Distortions)

Enterprise Values

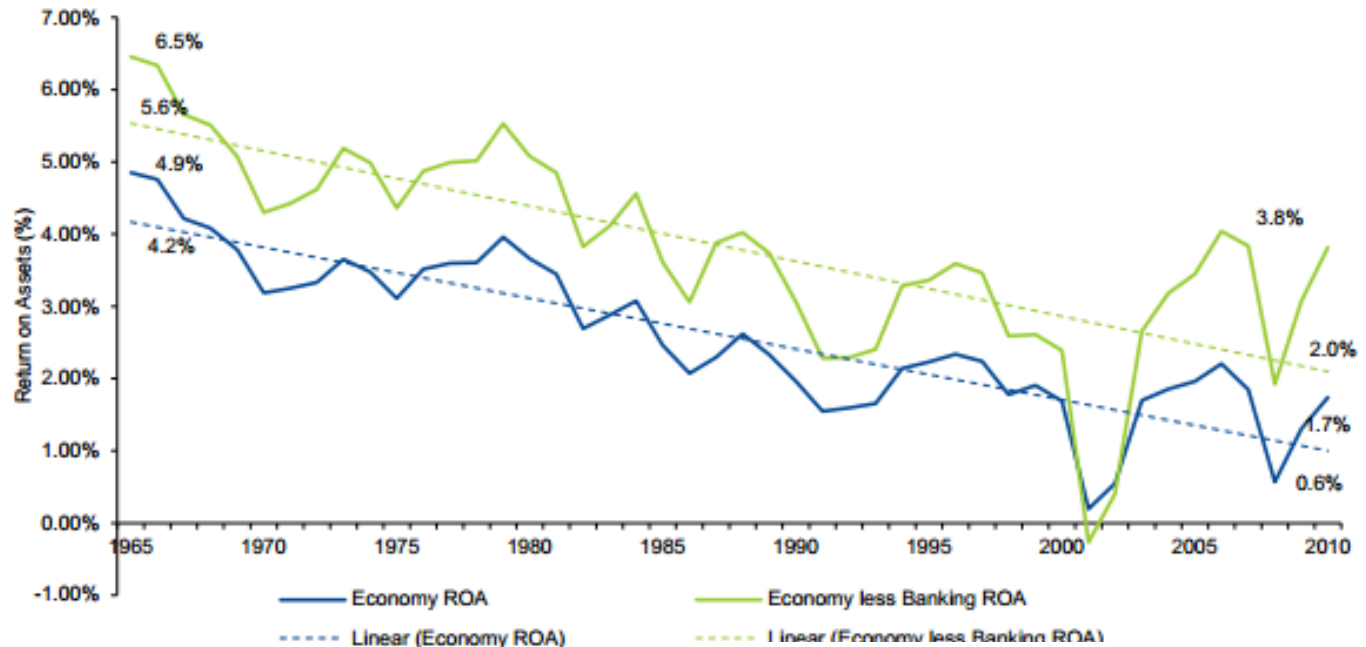
## Performance and Valuation Prime™ Analysis

4431 U.S. companies (non-financial)



# According to Deloitte EDGE Institute...

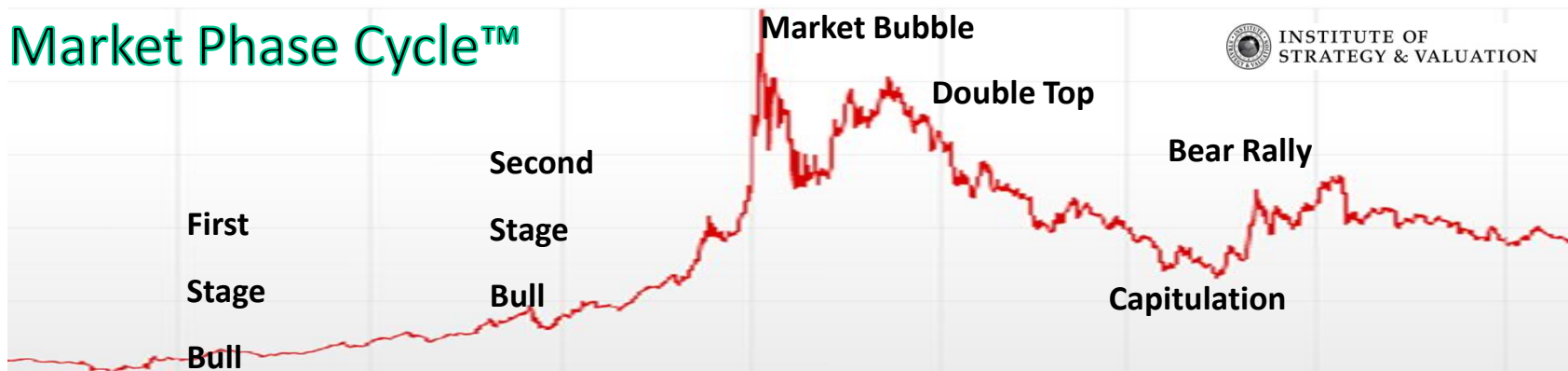
Exhibit 91: ROA for the U.S. Economy (1965-2010)



Source: Compustat, Deloitte analysis

... ROA for the U.S. economy has been in steady decline for the past 45 years. We believe that this decline in ROA has been driven by companies' inability to adapt to the long-term trends behind the Big Shift.

# Market Phase Cycle™



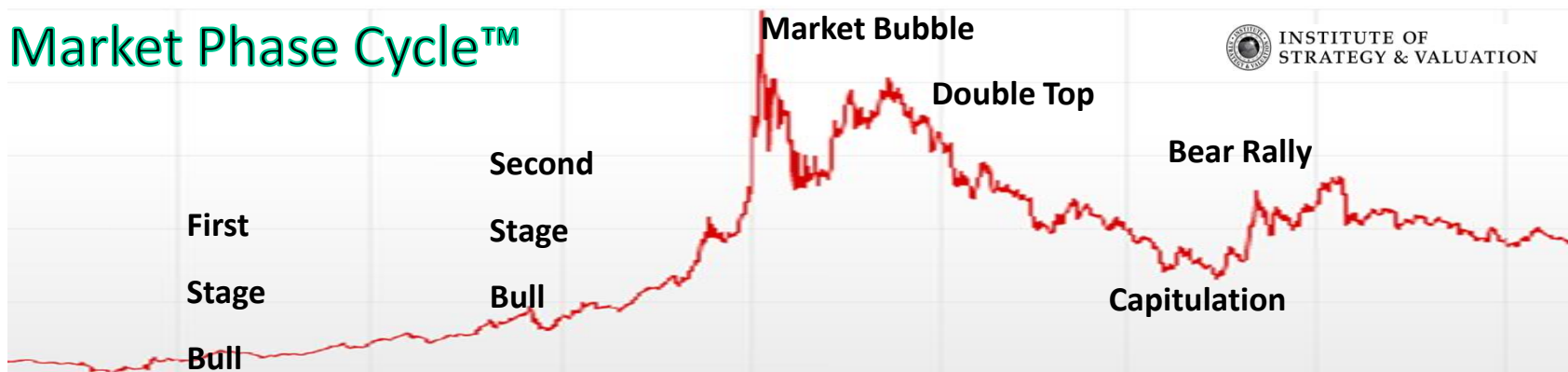
**BULL CYCLE** ————— ● **BEAR CYCLE** ————— ●

**CORPORATE PROFIT INCREASING** ————— ● **PROFIT COLLAPSING** ————— ●

**MULTIPLE EXPANSION** ————— ● **MULTIPLE COMPRESSION** ————— ●

**CREDIT EASING** ————— ● **CREDIT TIGHTENING** ————— ● **CREDIT EASING** ————— ●

# Market Phase Cycle™



**BULL CYCLE** ————— ● **BEAR CYCLE** ————— ●

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**CREDIT EASING** ————— ● **CREDIT TIGHTENING** ————— ● **CREDIT EASING** ————— ●

————— ● **Credit Demand Increasing** ————— ● **Credit Demand Falling** ————— ●



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*"If the rating agencies will downgrade only when we can all see the losses, then why do we need the rating agencies?"*

- Jim Chanos, the head of Kynikos Associates

*"...the ratings that were developed by the credit rating agencies were a major factor in the cause of the problems..."*

- Federal Reserve Chairman Alan Greenspan re: the 2007-2009 crisis

*"The ratings agencies, basically, without looking at the underlying bond, they just pretty much gave almost everything that came out AAA ratings,"*

- Smith, West Virginia Labourers Trust Fund, \$300 million pension fund

## Moody's Credit Opinion – December 9, 2013

Delta Air Lines Inc.

Moody's Rating: B2 (HY2)

Valens Credit Rating: XO (Baa3)

Passenger Airlines Industry [1][2]	Current LTM 9/30/2013		[3]Moody's 12-18 month Forward View - as of 12/2013	
Factor 1: Cost Structure (16%)	Measure	Score	Measure	Score
a) Fleet Age (average in years)	Caa	Caa	Caa	Caa
b) EBITDA Margin	17.5%	B	17.5% - 18.5%	B
<b>Factor 2: Market Conditions (28%)</b>				
a) Business Profile	Ba	Ba	Ba	Ba
b) Geographic Diversity	Ba	Ba	Ba	Ba
<b>Factor 3: Coverage and Leverage (36%)</b>				
a) EBIT/Interest	2.0x	B	2.2x - 2.4x	Ba
b) RCF/Net Debt	14.4%	B	16.0% - 18.0%	Ba
c) Debt/EBITDA	5.2x	Ba	4.6x - 4.9x	Ba
<b>Factor 4: Financial Policy (20%)</b>				
a) Financial Policy	Ba	Ba	Ba	Ba
<b>Rating:</b>				
a) Indicated Rating from Grid		Ba3		Ba3
b) Actual Rating Assigned		B1		

“To be successful, you should concentrate  
on the world of companies,  
not arcane accounting mathematics.”

-- Buffett

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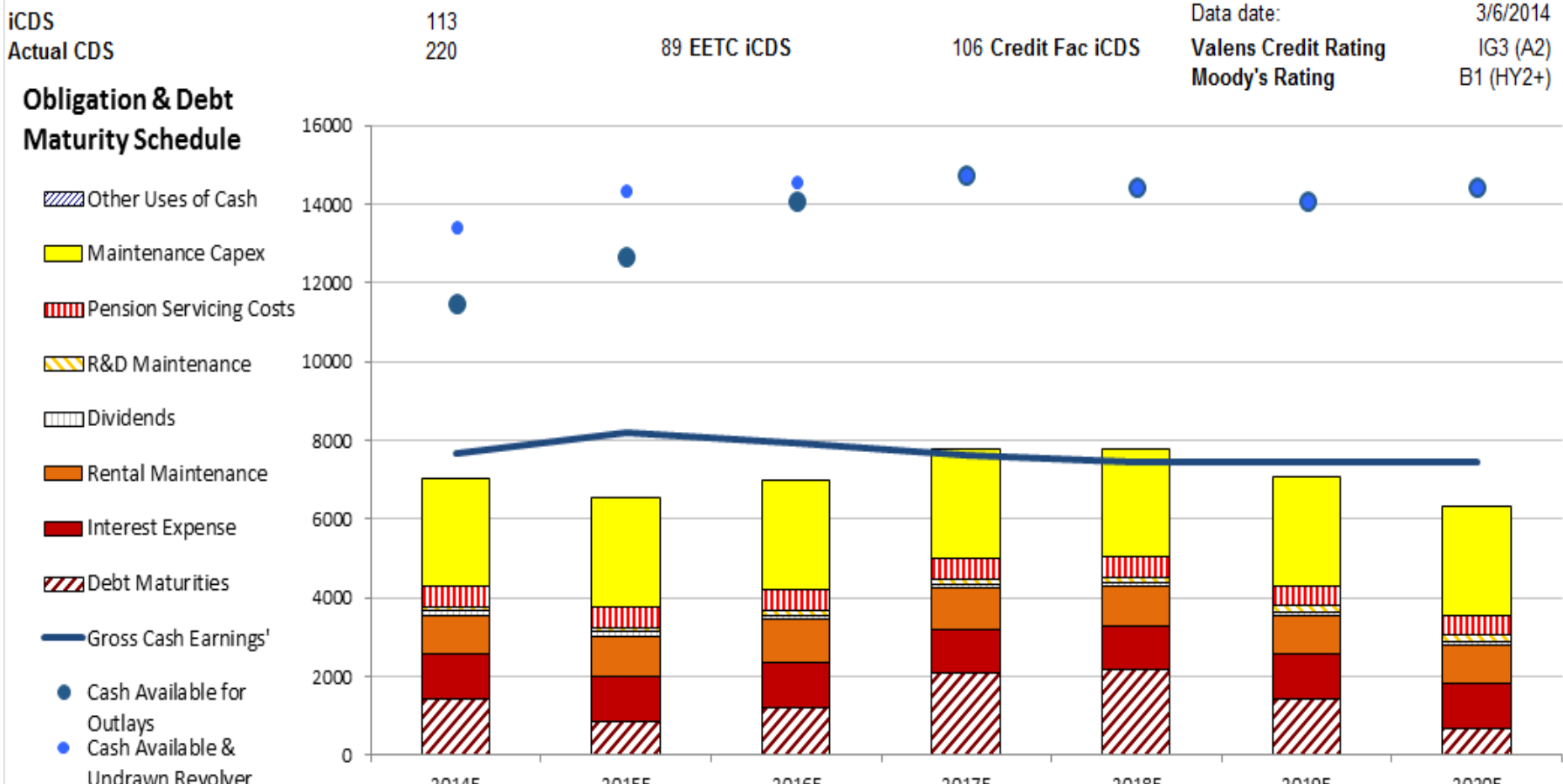
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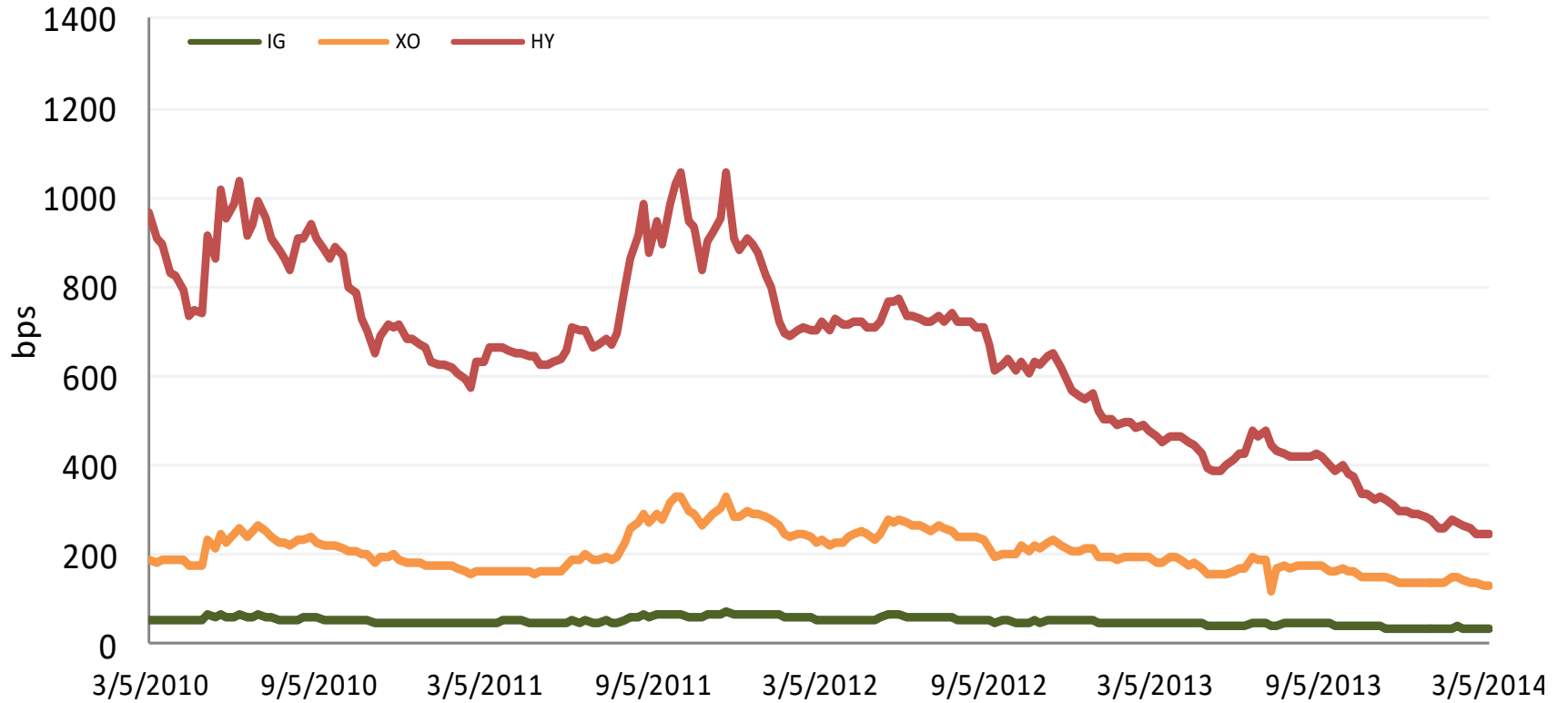
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# Delta Air Lines Inc.(NYSE:DAL)



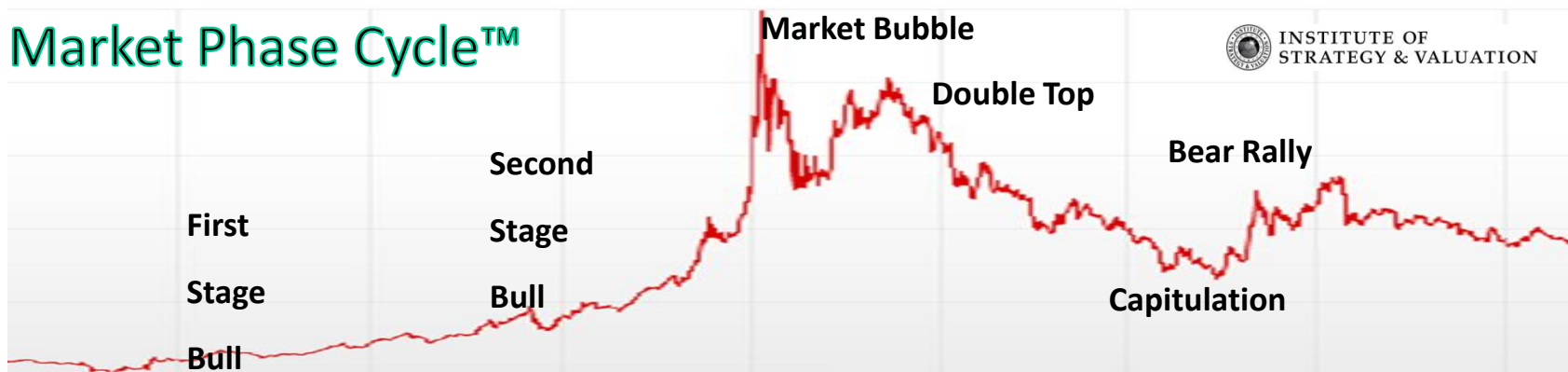
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# Valens Custom Aggregate CDS Index



Data Date: Four Years through March 07, 2014

# Market Phase Cycle™



**BULL CYCLE** ————— ● **BEAR CYCLE** ————— ●

**CORPORATE PROFIT INCREASING** ————— ● **PROFIT COLLAPSING** ————— ●

**MULTIPLE EXPANSION** ————— ● **MULTIPLE COMPRESSION** ————— ●

**CREDIT EASING** ————— ● **CREDIT TIGHTENING** ————— ● **CREDIT EASING** ————— ●

————— ● **Credit Demand Increasing** ————— ● **Credit Demand Falling** ————— ●

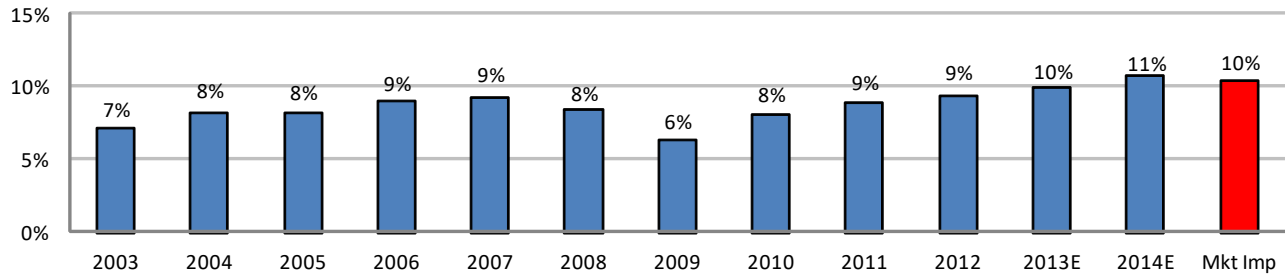
————— ● **Net New Investing** ————— ● **Divesting** ————— ●



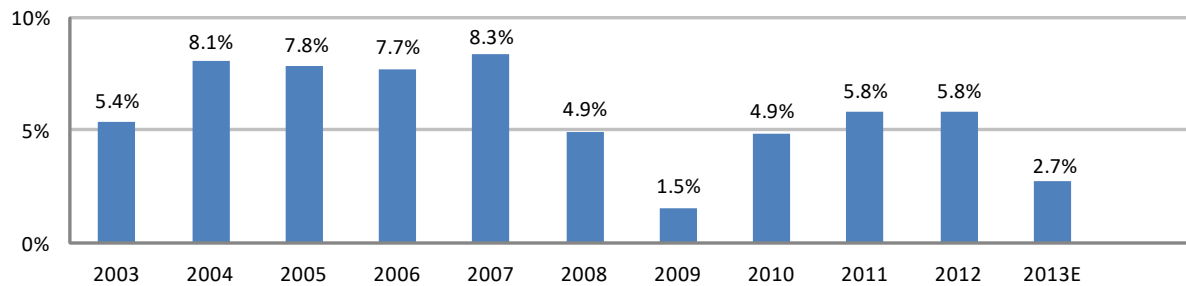
## Performance and Valuation Prime™ Analysis

4431 U.S. companies (non-financial)

ROA'



Asset'  
Growth



“...if the CEO, wants to obfuscate, they can do that; and if they want to make it clear, they can do that.

If they want to provide you with fluff, they can do that.

If they want to provide you with substance, they can do that...

...as a way to give his shareholders more information, or to do some kind of tap dance number.

-- Buffett as quoted by Laura Rittenhouse  
in *“Investing Between the Lines”*

# COGNITIVE AND EMOTION ANALYSIS

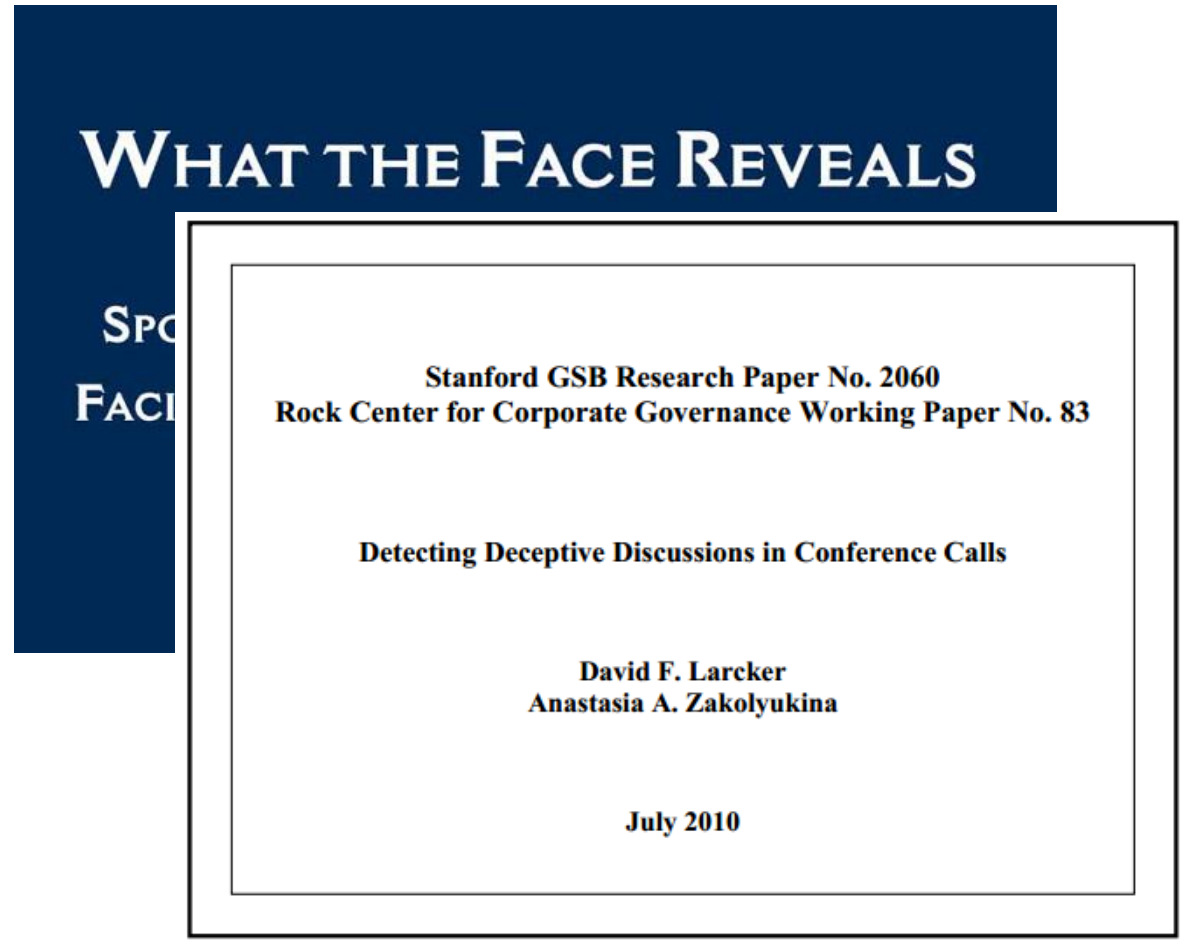
- VISUAL

## WHAT THE FACE REVEALS BASIC AND APPLIED STUDIES OF SPONTANEOUS EXPRESSION USING THE FACIAL ACTION CODING SYSTEM (FACS)

EDITED BY  
PAUL EKMAN  
ERIKA L. ROSENBERG

# COGNITIVE AND EMOTION ANALYSIS

- VISUAL
- LINGUISTIC



# COGNITIVE AND EMOTION ANALYSIS

- VISUAL
- LINGUISTIC
- AUDIO

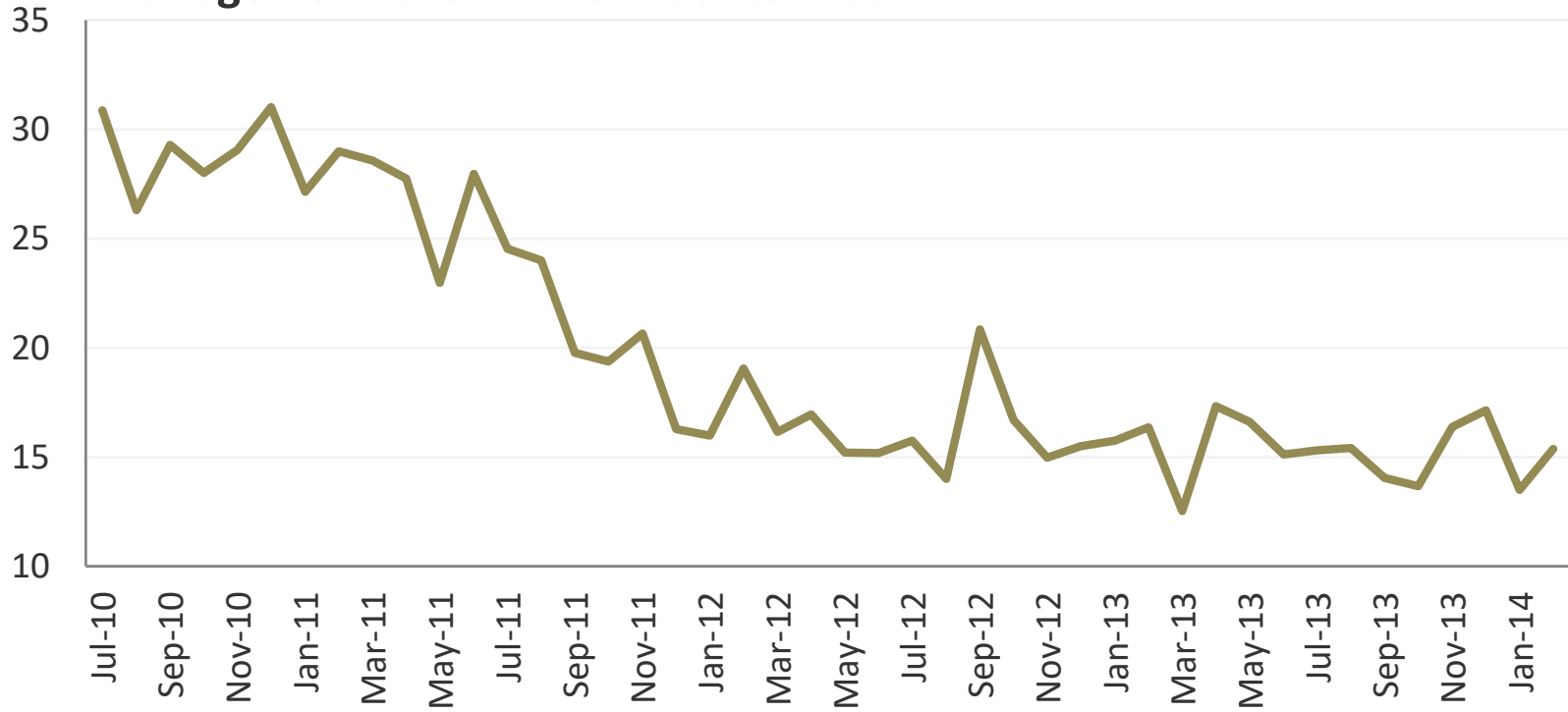
## WHAT THE FACE REVEALS

SPC  
FACI

Stanford GSB Research Paper No. 2060  
Rock Center for Corporate Governance Working Paper No. 83



## Management Growth Confidence Index



Data Frequency: Monthly - as of February 2014

“We like positive surprises  
and upward earnings revisions  
and bigger than expected gains.”

-- Richard Driehaus

VIPS



# Market Phase Cycle™



**BULL CYCLE** ————— ● **BEAR CYCLE** ————— ●

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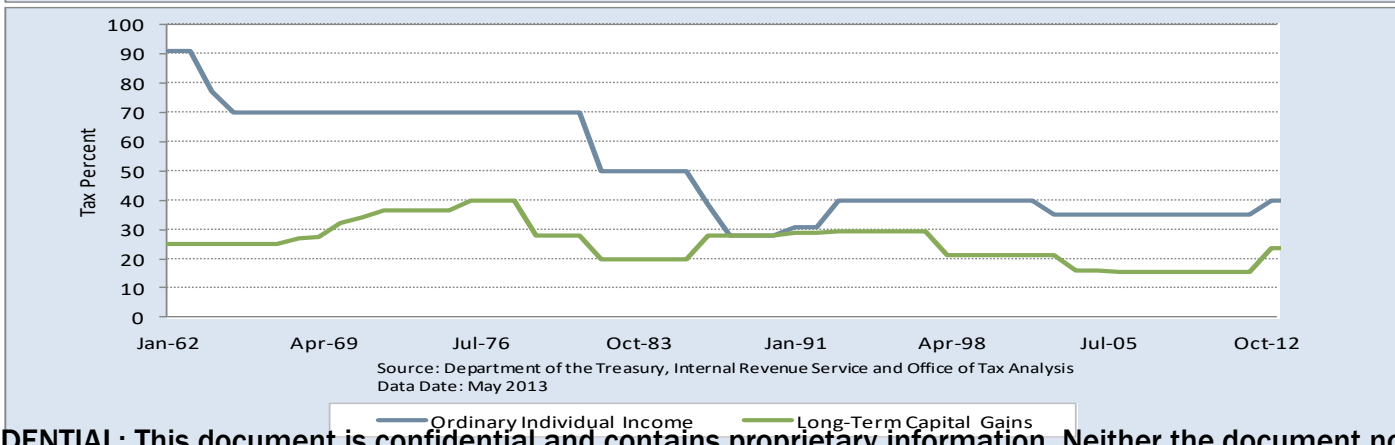
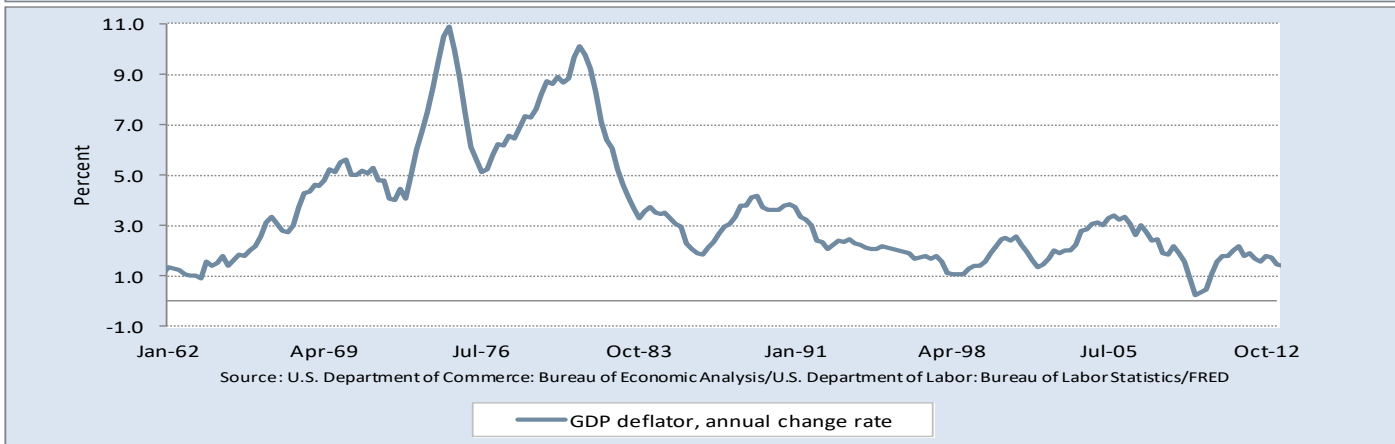
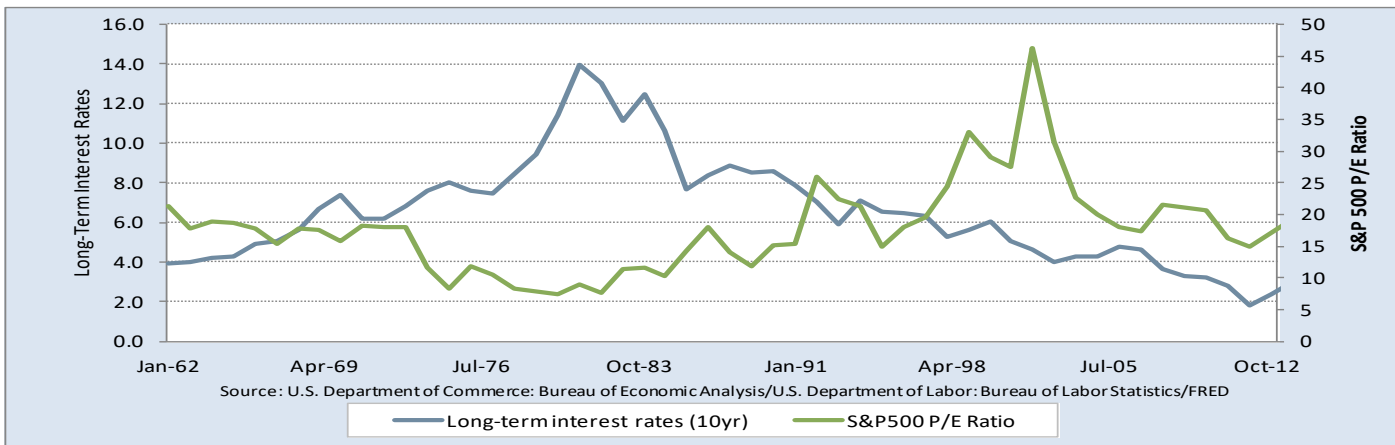
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————— ● **Net New Investing** ————— ● **Divesting** ————— ●

————— **LEADING AND LAGGING ECONOMIC INDICATORS** —————

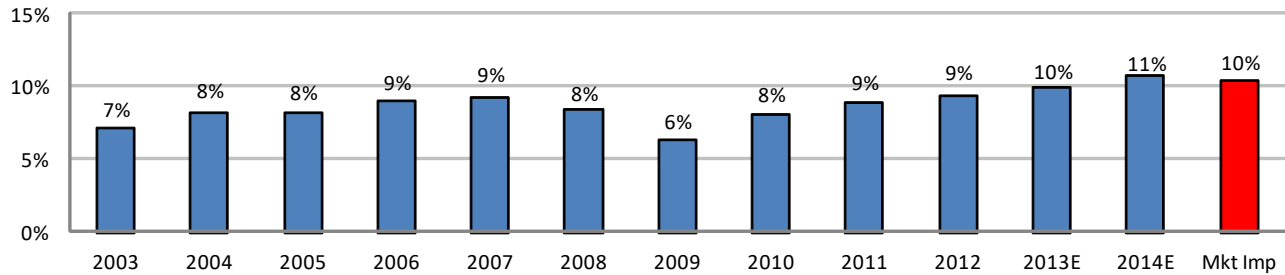


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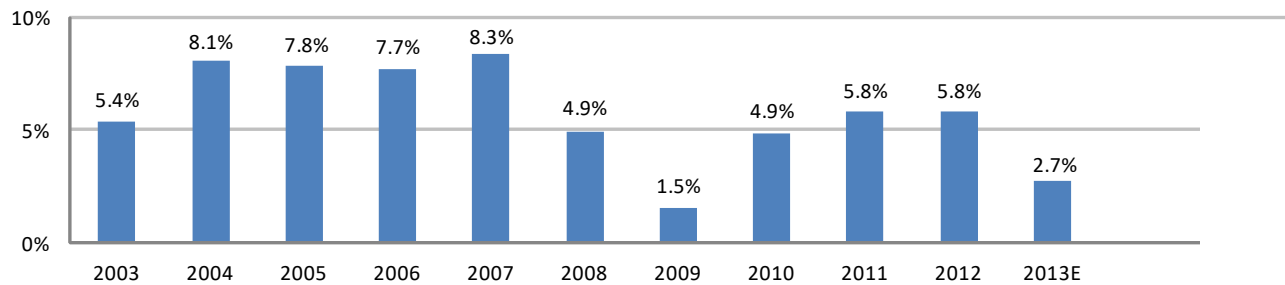
## Performance and Valuation Prime™ Analysis

4431 U.S. companies (non-financial)

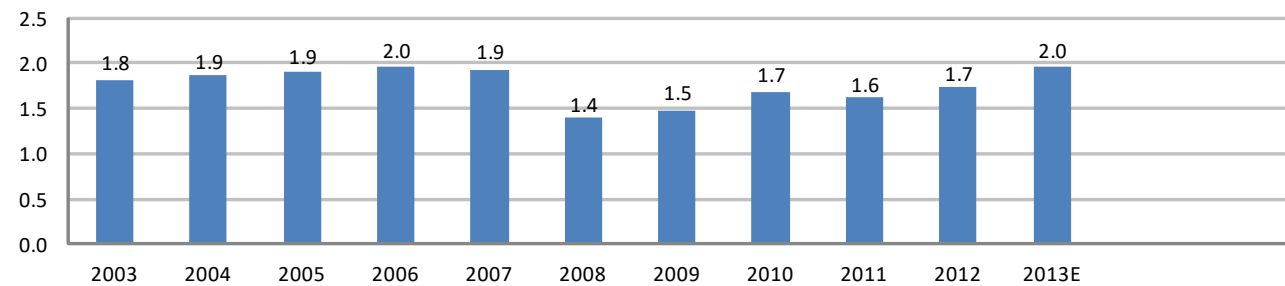
ROA'



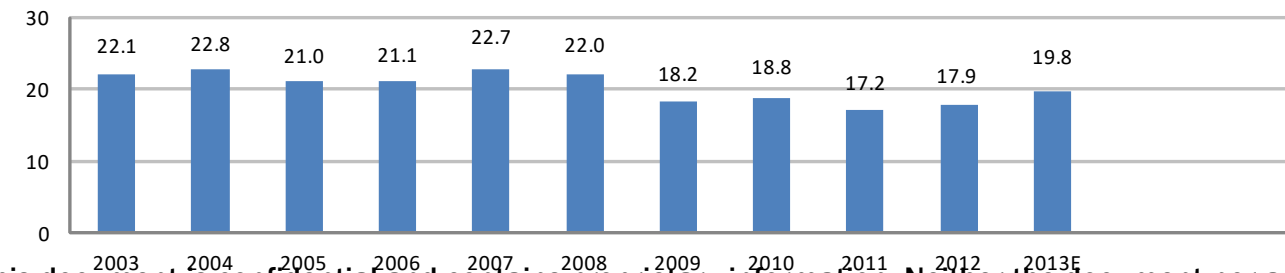
Asset'  
Growth



V/A'



V/E'



# Market Phase Cycle™



**BULL CYCLE** ————— ● **BEAR CYCLE** ————— ●

**CORPORATE PROFIT INCREASING** ————— ● **PROFIT COLLAPSING** ————— ●

**MULTIPLE EXPANSION** ————— ● **MULTIPLE COMPRESSION** ————— ●

**CREDIT EASING** ————— ● **CREDIT TIGHTENING** ————— ● **CREDIT EASING** ————— ●

————— ● **Credit Demand Increasing** ————— ● **Credit Demand Falling** ————— ●

————— ● **Net New Investing** ————— ● **Divesting** ————— ●

————— **LEADING AND LAGGING ECONOMIC INDICATORS** —————

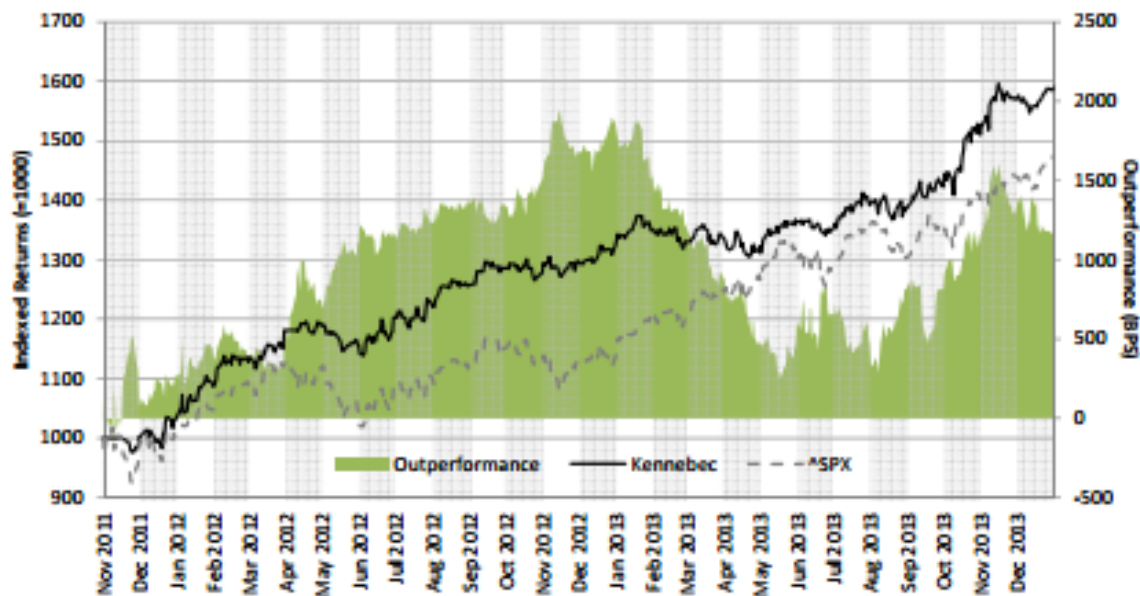
# IN 26 MONTHS, 58+% RETURNS, WITH LOW NET MARKET EXPOSURE

In our first 26 months, our long/short equity strategy in US large, mid, and small cap stocks yielded 58+% returns beating the SP500 by 1100+ basis points.

Daily Return Stats

Beta	R <sup>2</sup>
0.56	0.51

Daily Indexed Returns: Kennebec vs. ^SPX



Exposure	Long	Short	Net
Nov 2011	34.1%	0.0%	34.1%
Dec 2011	70.4%	0.0%	70.4%
Jan 2012	60.9%	0.0%	60.9%
Feb 2012	46.3%	0.0%	46.3%
Mar 2012	66.3%	0.0%	66.3%
Apr 2012	33.4%	0.0%	33.4%
May 2012	41.6%	0.0%	41.6%
Jun 2012	58.4%	0.0%	58.4%
Jul 2012	60.6%	0.0%	60.6%
Aug 2012	33.9%	0.0%	33.9%
Sep 2012	46.3%	3.0%	43.3%
Oct 2012	48.1%	7.5%	40.6%
Nov 2012	49.2%	4.7%	44.5%
Dec 2012	66.3%	13.2%	53.1%
Jan 2013	50.9%	17.4%	33.5%
Feb 2013	64.1%	15.9%	48.1%
Mar 2013	83.9%	3.2%	80.7%
Apr 2013	75.0%	24.1%	50.9%
May 2013	64.7%	29.3%	35.5%
Jun 2013	68.0%	10.1%	57.8%
Jul 2013	88.8%	8.4%	80.3%
Aug 2013	85.0%	11.3%	73.7%
Sep 2013	79.9%	3.3%	76.6%
Oct 2013	73.4%	10.7%	62.7%
Nov 2013	69.2%	24.4%	44.8%
Dec 2013	68.0%	10.1%	57.8%

# Kennebec River Capital

## Long/Short Equity Hedge Fund

Kennebec	Q1	Q2	Q3	YTD
2011				3.00%
2012	14.73%	1.79%	6.82%	28.54%
2013	1.56%	0.19%	5.60%	20.00%
				<b>58.87%</b>

*Source: Kennebec River Capital*

# Kennebec River Capital

## Long Equity Only Strategy

Kennebec	Q1	Q2	Q3	YTD
2011				3.00%
2012	14.73%	1.79%	6.83%	30.08%
2013	3.00%	1.23%	7.27%	27.06%
				<b>70.25%</b>

*Source: Kennebec River Capital*

# Kennebec River Capital

## Long Stock Pick Performance (not a Strategy)

Kennebec	Q1	Q2	Q3	YTD
2011				1.36%
2012	23.42%	3.05%	14.35%	56.45%
2013	4.68%	1.18%	9.94%	37.22%
				<b>117.59%</b>

*Source: Kennebec River Capital*





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INSTITUTE OF STRATEGY & VALUATION

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## “How to Beat the Market”

Professor Joel Litman

April 2014

“Be fearful when others are greedy, and greedy when others are fearful” Julian Robertson, The Tiger Funds

“Success in investing doesn't correlate with I.Q. once you're above the level of 25. Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing.” Buffett

“You can continue to expect us to provide careful attention during periods of stock market craziness as we attempt to use the 'madness of crowds' to our advantage.” Royce

When the market is inefficient, why opportunities arise:

When the market is inefficient, why opportunities arise:

“When the herd is single-mindedly focused... prices are frequently bid up and returns driven down.” Klarman

“It’s unnatural for humans to think totally different from the crowd.” Brandes

“I'd be a bum on the street with a tin cup if the markets were efficient.” Buffett

## How to beat the market

Understand the market's valuation and what drives it

“Embedded Expectations”

Know the market is going to change its mind

“Mispricing”

Make a position *reasonably prior* to the market doing that

“Catalyst”

Informational Advantage

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Investigative Investing

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Analytical Advantage