

The Litman Letter

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Buying Inexpensive, High Quality, Growing Firms: A History of Outperformance When Screening with Uniform Accounting UAFRS*-Based Metrics

...and which are those 30 stocks today?

What happens if each year, one simply buys the 30 companies that exhibit high levels of economic profitability (high UAFRS-based return on assets), continued business re-investment (high UAFRS-based asset growth) and yet still screen inexpensive (lower UAFRS-based P/E multiples)?

Since 1998, the 30 highest quality/highest growth companies, with the least expensive stock prices, crush the market with an amazing performance of about 15% per annum versus the S&P500's 5.2% over the same period.

What are those 30 stocks today? When screening on uniform accounting, one sees a very different group of firms than using traditional as-reported metrics. AAPL AVGO, CRUS, GILD and LRCX are a few of those names.

Hope you enjoy this month's letter, and hope that some of these ideas help your portfolio generate outsized stock returns in the coming year.

**UAFRS: Uniform Adjusted Financial Reporting Standards a.k.a. Uniform Accounting*

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What ideas made it this year?

Here is a sample of five of the thirty stock ideas that made the screen based on 2016 performance and suggest higher potential returns for the coming 12 months.

The full list is on the last page of this letter. They all follow a similar pattern of high quality, high growth, and inexpensive valuation.

One is highly unlikely to see these same stock ideas, nor the same names in any year of the last 18+ years, using as-reported metrics in most databases. The difference is Uniform Accounting – UAFRS-based metrics. (Uniform Adjusted Financial Reporting Standards.)

AAPL – On the list in 9 of the past 10 years, AAPL's 2016 Adjusted ROA of 83% is still 13x above corporate averages, even after declining from a high of 159%. AAPL continues to grow its Adjusted Assets in excess of 15% annually, while valuations remain low, with a 12.5x Adjusted P/E

AVGO – The company has been able to reach record-high Adjusted ROA while maintaining robust, +25% Adjusted Asset growth for the past three years, while valuations have only reached 15.8x. The market is pricing in a negative inflection in the firm's profitability

CRUS – Since becoming economically profitable in 2012, the firm has been able to sustain Adjusted ROAs in excess of 20%, while growing their Adjusted Asset base by 10-46% for the past seven years. However, valuations are not reflective of the firm's sustainable competitive advantage and growth opportunities, as their Adjusted P/E remains at 14.4x

GILD – Markets are pricing in expectations for the firm's profitability to fade to 2x corporate averages, a significant drop from their current 82% Adjusted ROA. Paired with consistent +14% annual Adjusted Asset growth over the past five years and a 6.9x Adjusted P/E, the firm's valuation is not pricing in their profitability or their growth potential

LRCX - With a 9.7x Adjusted P/E, near historical lows, markets are not pricing in the firm's sustained +20% Adjusted ROAs or their consistently robust 5-20% Adjusted Asset growth

(The full list is on the last page of this letter.)



Where did the ideas come from?

Using the UAFRS uniform accounting framework, we identified companies that exhibit three signals, high quality (high UAFRS-based ROA), growth-oriented (high UAFRS-based Asset growth), and inexpensive valuation (low UAFRS-based P/E) dating back to 1999.

Ranking companies by UAFRS-based ROA identifies companies that are performing well above corporate averages. Companies that consistently generate Adjusted ROA in excess of corporate averages (6%) have found a way to fulfill otherwise unmet customer needs. Their offerings are differentiated, their businesses are innovative, and over time generate sustained returns through sustained competitive advantages.

In addition, the Adjusted Asset growth signal component factors in companies' ability to continually invest assets at such high returns. The firms show an ability to effectively integrate new assets into their operations or new businesses altogether. Companies with consistently high Adjusted Asset growth are assessed as having greater future opportunities to generate higher free cash flows.

Finally, the Adjusted P/E metric identifies companies for whom, for some reason, the market is not pricing-in the high cash flow generation and investing activity already exhibited. Theoretically, and almost always observed, companies with high Adjusted ROA and high Adjusted Asset growth trade at premium valuations relative to their peers and the broader market.

For this reason, high quality, growth-oriented companies trading at a discount relative to market averages represent a strong buying opportunity.

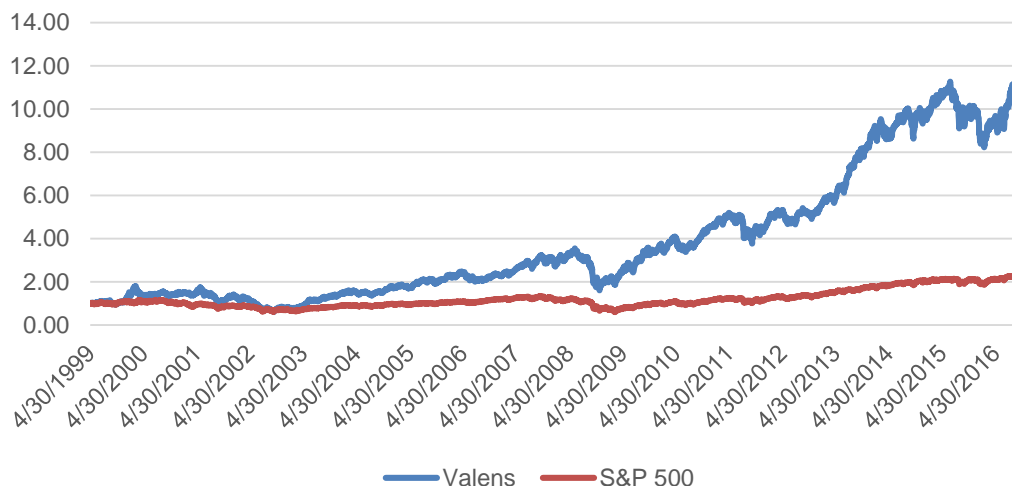
The universe of companies includes publicly-listed companies with a market cap of >\$1bn at the end of each year, and were listed on the NYSE or NasdaqGS exchanges. Firms were rank-ordered by prior year's Adjusted ROA, Adjusted Asset growth, and current year's Adjusted P/E to come up with an average score for each company in each year. Each year for the past 18 years, we examined the performance of that basket of 30 companies with the highest average scores. Each year's baskets were re-balanced on April 30th using the prior year's UAFRS-adjusted data.

On an annualized basis, this screen outperformed the S&P 500 by a wide margin: 15% vs. 5.2%.



UAFRS-based backtest

UAFRS Quality, Growth, and Undervalued vs. S&P 500



Source: Valens Research

In addition to outperforming the S&P 500 with a 15% annualized return compared to a 5.2% annualized return, Valens' portfolio had a 0.56 Information Ratio, a 0.52 Sharpe Ratio (versus a 0.18 Sharpe Ratio for the S&P over the same time period) and a 0.86 Sortino Ratio (versus a 0.28x Sortino Ratio for the S&P over the same time period).

For the 18-year period from 1999-2016, there were only 5 years (2002, 2006, 2011, 2014, and 2015) when the list did not outperform the market. The list's worst year came in 2002, when it underperformed the S&P by 21.2%. The second weakest year came in 2006, with 5.4% underperformance.

Meanwhile, of the 13 outperforming years, the screen showed 8 years of +10% outperformance, including +35% outperformance in 2000, 2003, 2009, and 2013.

Performance and Risk Metrics			
	Valens	S&P 500	Δ
Annualized Return	15.0%	5.2%	9.7%
Standard Deviation	25.2%	19.6%	5.7%
Information Ratio	0.56	-	
Sharpe Ratio	0.52	0.18	
Sortino Ratio	0.86	0.28	



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As the analysis indicates, when using UAFRS variables, selecting high-quality companies with strong growth and inexpensive valuations leads to consistent market outperformance. While each metric on its own would not identify a great set of outperforming stocks, in combination these variables identify a basket of firms that consistently exceed market and peer returns.

This year, the 2017 picks are heavily concentrated in technology and healthcare. Fourteen of the thirty names are technology stocks (AAPL, AVGO, BDC, BKFS, CRUS, IPHI, LRCX, NSR, NTCT, OTEX, SANM, SIMO, YY), while another ten are healthcare firms (ABBV, AKRX, CELG, FGEN, GILD, HZNP, JAZZ, MNK, UTHR, VRX).

The remaining six firms fall under energy (EQM, PSXP) and consumer discretionary (LTRP.A, SNI, TGNA, VIPS). Additionally, ten of the names remain on the list from the previous year's list (AAPL, AVGO, CRUS, EQM, FGEN, GILD, JAZZ, NTCT, NTES, YY).

A full breakdown of each year's annual picks and their overall performance relative to the S&P 500 over the time of the analysis is available at the end of this letter.

Until next time, more power to you in your investing.

Joel



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1999 Results

Performance		
Valens	S&P 500	Δ
21.0%	11.1%	9.8%

backtest Top 30 Companies: 12/31/1998				
ACIW	ADTN	ALV	AMZN	APA
CA	ESV	HAL	HAS	HP
HRB	INCY	KATE	KOF	LVLT
MATX	MDR	MLHR	MLI	NOV
PCAR	PCG	RAD	RDC	REV
RIG	TEN	TSX:TRP	USG	VIAV

Source: Valens Research

2000 Results

Performance		
Valens	S&P 500	Δ
25.7%	-9.7%	35.4%

backtest Top 30 Companies: 12/31/1999				
AAPL	AEP	ALK	AMT	BWA
DISH	DO	EIX	ESRX	GD
HRB	HRS	KBH	KOF	LEN
LVLT	MATX	MLHR	MSTR	MU
NEM	NI	NUS	PHM	PII
RHI	RSG	TSX:CNQ	USG	WDR

Source: Valens Research



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2001 Results

Performance		
Valens	S&P 500	Δ
-11.2%	-11.8%	0.5%

backtest Top 30 Companies: 12/31/2000				
AKAM	ALKS	AMKR	AMT	AUDC
BCOR	BSX	CGNX	EVLV	FNSR
GILD	GILT	HLIT	HRB	INAP
IT	KTOS	LSCC	LVL	MSI
MSTR	MTZ	RAI	RHT	RNWK
SIRI	TSX:CNQ	TWX	VIAB	VICR

Source: Valens Research

2002 Results

Performance		
Valens	S&P 500	Δ
-42.8%	-21.6%	-21.2%

backtest Top 30 Companies: 12/31/2001				
ALE	ALKS	AMCC	AMZN	CCI
CIEN	DO	DOX	ETM	EVC
EXTR	INCY	IR	ISCA	MATX
NBL	NFX	NVR	PTEN	PWR
QTM	RIG	RMD	RNWK	SBAC
SONS	TK	TTEK	VRTX	YHOO

Source: Valens Research



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2003 Results

Performance		
Valens	S&P 500	Δ
82.9%	28.2%	54.7%

backtest Top 30 Companies: 12/31/2002				
ACN	BVN	CAR	CERN	CHKP
DHI	ENDP	FLWS	HRB	KOF
LEN	MDC	MRVL	MYGN	NKTR
NLS	NSIT	NUE	NVDA	NVR
PDLI	PII	PLT	PTNR	RAI
REGN	SLAB	TSX:CNQ	VRTX	VRX

Source: Valens Research

2004 Results

Performance		
Valens	S&P 500	Δ
27.4%	10.7%	16.7%

backtest Top 30 Companies: 12/31/2003				
ADS	AGCO	CACI	CERN	CHK
CHKP	CPRT	DE	DHI	DLX
DOX	F	KBH	KOF	LEN
MDC	MU	MYL	NVR	OSK
PFE	PHM	PTNR	TOL	UGP
UNH	UTSI	VRTX	VRX	WDC

Source: Valens Research



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2005 Results

Performance		
Valens	S&P 500	Δ
17.7%	4.8%	12.9%

backtest Top 30 Companies: 12/31/2004				
ACN	ANTM	CAA	COP	DHI
DLX	DRD	HOV	KBH	KOF
LEN	MAT	MDC	NEM	NTES
NUE	NVR	PHM	RS	SCCO
STLD	THO	TOL	TTWO	UVV
VLO	VRX	WDC	WYNN	YHOO

Source: Valens Research

2006 Results

Performance		
Valens	S&P 500	Δ
10.5%	15.8%	-5.4%

backtest Top 30 Companies: 12/31/2005				
ARLP	ATU	BSX	CHKP	CLF
COP	ETP	GILD	GRMN	HLF
HLX	IDCC	KOF	LRCX	MTH
NTES	NVR	OSK	OXY	PTEN
SCHN	SYMC	TPX	TSO	USG
UTSI	VLO	VRSN	VRX	WDC

Source: Valens Research



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2007 Results

Performance		
Valens	S&P 500	Δ
32.1%	5.1%	27.0%

backtest Top 30 Companies: 12/31/2006				
ARLP	BVN	CHKP	COO	COP
ELNK	ENDP	ETP	EXPE	FCN
GRMN	HFC	HLF	HOLX	HP
HRB	MTL	NOV	NTES	OSK
PTEN	RS	SCCO	SPN	STLD
SYMC	TEVA	VLO	WCG	WDC

Source: Valens Research

2008 Results

Performance		
Valens	S&P 500	Δ
-32.8%	-36.8%	4.0%

backtest Top 30 Companies: 12/31/2007				
AAPL	ACN	ALR	ARRS	ATW
BIIB	CHKP	CMPR	CROX	DLB
ENDP	FFIV	FORM	HOLX	IART
IEP	JCOM	LBTY.A	LRCX	MTL
MYGN	MYL	NTES	OIS	OSK
SCHN	SGMS	SPN	VRX	WDC

Source: Valens Research



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2009 Results

Performance		
Valens	S&P 500	Δ
68.3%	26.4%	41.9%

backtest Top 30 Companies: 12/31/2008				
AAPL	AMCN	AMED	CHKP	CRK
CTSH	DNR	EBAY	ENDP	GRMN
HLF	INFN	JCOM	LULU	MD
MIDD	MTL	MYGN	MYL	NE
NOV	NTES	NUE	PCAR	RES
SIGM	SM	TPC	TSL	UTIW

Source: Valens Research

2010 Results

Performance		
Valens	S&P 500	Δ
30.2%	15.1%	15.1%

backtest Top 30 Companies: 12/31/2009				
AAPL	ATVI	BIIB	CACI	CLF
DECK	EEP	ENDP	GD	GILD
GRMN	HAS	HLF	IDCC	IEP
INT	KOF	LRCX	MDRX	MYGN
MYL	NTES	ORCL	PFE	PTNR
QCOM	SOHU	TPC	TTEK	WDC

Source: Valens Research



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2011 Results

Performance		
Valens	S&P 500	Δ
-1.2%	1.9%	-3.1%

backtest Top 30 Companies: 12/31/2010				
AAPL	ACN	ARLP	ATU	CELG
CLF	CSIQ	DISH	DLB	ENDP
GILD	GRMN	IEP	INT	MA
MD	MSCC	MTL	NRS	NTES
OSK	SKX	SMTc	SYNA	TDG
TTEK	VECO	VRX	WDC	YGE

Source: Valens Research

2012 Results

Performance		
Valens	S&P 500	Δ
17.9%	16.0%	1.9%

backtest Top 30 Companies: 12/31/2011				
AAPL	ARLP	ATVI	BORN	CO
CPLA	CVI	CVLT	DECK	DLB
EBAY	ENDP	ESRX	HFC	HOLX
IPGP	NTES	SEP	SFUN	SHOO
SNI	SYNA	SYNT	TEVA	TGA
TTEK	VIP	VRX	WDC	WDR

Source: Valens Research



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2013 Results

Performance		
Valens	S&P 500	Δ
67.6%	32.3%	35.3%

backtest Top 30 Companies: 12/31/2012				
AGN	ALR	ARLP	AVGO	BPI
CACI	CELG	CO	CRUS	CTRP
CVLT	DLB	ESRX	GOOGL	GPOR
HLF	JAZZ	JCOM	JW.A	MIDD
NTES	QCOM	SFUN	SHOO	SSNC
TEVA	TTEK	UTHR	VRX	WDC

Source: Valens Research

2014 Results

Performance		
Valens	S&P 500	Δ
9.9%	13.5%	-3.6%

backtest Top 30 Companies: 12/31/2013				
AAPL	ARLP	ARRS	AVGO	BCEI
CATM	CVLT	ENDP	EQM	GILD
JAZZ	JCOM	KOF	LQDT	LRCX
MIC	NSR	NTES	PBH	POST
SAFM	SPGI	SFLY	SWKS	THO
TRN	VIP	WDC	WNY	YY

Source: Valens Research



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2015 Results

Performance		
Valens	S&P 500	Δ
-0.9%	1.2%	-2.1%

backtest Top 30 Companies: 12/31/2014				
AAPL	ABCO	AMCX	ARRS	AVGO
CBI	CLR	CRUS	GILD	HLF
ICON	ISIL	LCI	LL	MYGN
NSR	NTES	PBH	POST	RGR
SALE	SANM	SFLY	SSYS	SYNA
THO	TRN	UBNT	WNR	YY

Source: Valens Research

2016 Results

Performance		
Valens	S&P 500	Δ
20.2%	12.6%	7.6%

backtest Top 30 Companies: 12/31/2015				
AAPL	AVGO	CALM	CRUS	DATA
EQM	ESRX	EXAM	FGEN	GILD
GPRO	HCLP	IDCC	ISIL	JAZZ
LBRD.K	LCI	LOCK	NTCT	NTES
PINC	PRGO	SAIC	SANM	SWKS
SYNT	THO	UBNT	YY	ZBRA

Source: Valens Research



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2017 backtest Picks – Full List

backtest Top 30 Companies: 12/31/2016				
AAPL	ABBV	AKRX	AVGO	BDC
BKFS	CELG	CRUS	EQM	FGEN
GILD	HZNP	IPHI	JAZZ	LRCX
LTRP.A	MNK	NSR	NTCT	NTES
OTEX	PSXP	SANM	SIMO	SNI
TGNA	UTHR	VIPS	VRX	YY

Source: Valens Research

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