FATALPHA
VALUE INVESTING

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INSIDE CURRENT ISSUE

The S&P 500 rose 2.6% in July. This puts year to date return at 3.7% (including reinvested dividends) compared to FatAlpha at 2.4%. FatAlpha's two largest gains came from Trinity Industries and Sanmina as they rose 11% and 9% respectively, while the largest losses came from Triple-S at -16% and Insight Enterprises at -10%. Triple-S is a health care provider in Puerto Rico and recent news of a restructuring of local government debt pushed the stock down. I'll be waiting for earnings and the conference call before making a decision on the stock.

Regarding the market, investors should reduce their potential profit expectations to say the least. This is not based on some theoretical model but on the fact that many stocks are fully valued. The result of this, is that stocks struggle to appreciate even on good earnings. Let's look at some examples. Apple beat expectations but the stock dropped. Bloomberg and CNBC will tell you it was because the beat wasn't as large as usually or because the watch only sold 1.9m pieces instead of an expected 3-5m or some other bogus reason. The watch was actually a huge success as it sold more pieces than the original iphone and ipad on launch. The real problem with Apple is the valuation. If we use the 5-year average high of P/S, P/Bk and P/E and apply them to Bloomberg estimates then we get a target price of $131. I can already see some of you shaking your heads and pointing to all the cash flow and the cash on the balance sheet. But even if Apple continues to generate $50bn a year in free cash flow, I put a DCF value at $132 using a 10% discount factor and $146 using a 9% factor. More importantly, we need to ask where does Apple fit in? It's no longer a value stock as value investors seek much deeper discounts, and it's questionable as a growth stock. The company is so large right now that it's difficult to move the needle. Not to mention the reliance on the iphone product will constantly be brought up. Keep in mind that I do love the products and I continue to like the overall story, but a great company is not always a great stock.

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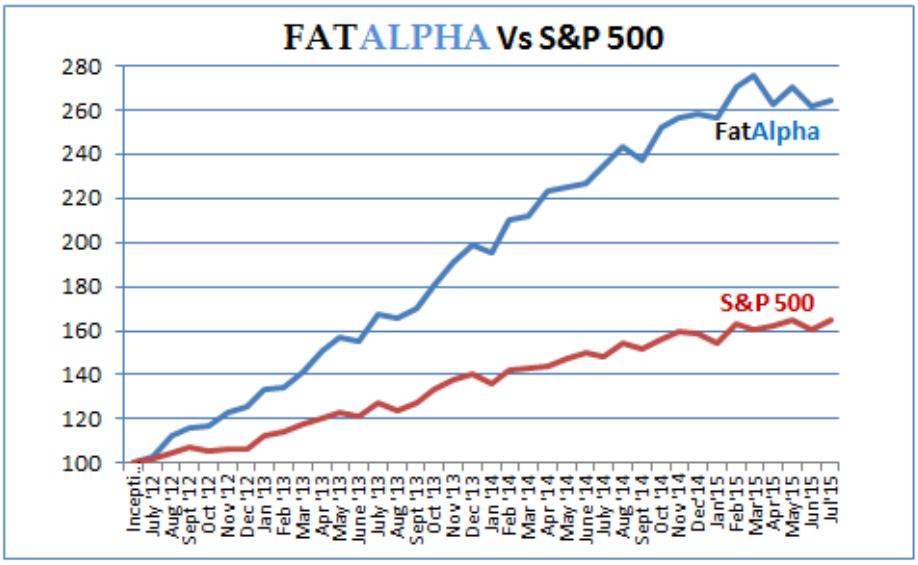
Performance

MONTHLY PERFORMANCE								
Yr/Mo	2015		2014		2013		2012	
	FatAlpha	S&P 500	FatAlpha	S&P 500	FatAlpha	S&P 500	FatAlpha	S&P 500
January	-0.83%	-2.51%	-1.76%	-3.09%	6.45%	5.72%		
February	5.49%	5.62%	7.64%	4.55%	0.71%	1.28%		
March	1.84%	-2.01%	0.91%	0.39%	5.35%	3.34%		
April	-4.80%	1.35%	5.08%	1.06%	6.47%	2.29%		
May	3.11%	1.29%	0.97%	2.32%	4.19%	2.36%		
June	-3.24%	-2.49%	0.83%	1.58%	-0.73%	-1.85%		
July	1.14%	2.64%	3.17%	-0.95%	7.45%	5.60%	2.89%	2.37%
August			3.67%	3.95%	-1.00%	-3.00%	9.12%	2.51%
September			-2.39%	-1.84%	2.78%	2.66%	3.03%	1.99%
October			6.21%	2.74%	6.26%	5.05%	0.66%	-1.36%
November			1.78%	2.75%	5.50%	2.96%	5.58%	0.57%
December			0.86%	-0.80%	4.34%	2.04%	1.79%	0.18%
Year	**2.35%**	3.67%	**29.95%**	13.08%	**59.01%**	31.97%	**25.14%**	6.36%
FatAlpha beat S&P 500 28 out of 37 months								

S&P DOWN MONTHS		
Month	FatAlpha	S&P 500
Oct-12	0.66%	-1.98%
Jun-13	-0.73%	-1.50%
Aug-13	-1.00%	-3.13%
Jan-14	-1.76%	-3.56%
Jul-14	3.17%	-1.51%
Sep-14	-2.39%	-1.55%
Dec-14	0.86%	-0.80%
Jan-15	-0.83%	-2.51%
Mar-15	1.84%	-2.01%
Jun-15	-3.24%	-2.49%
Average	-0.34%	-2.10%
FatAlpha beat S&P 500 8 out 10 times		



SINCE INCEPTION:	FatAlpha	164.7%	Vs	S&P 500	64.5%

The S&P 500 benchmark used in the figures above are based on the SPDR S&P 500 ETF (SPY) with after-tax (15%) dividends reinvested. The performance figures for FatAlpha are based on the portfolio manager's personal account and include all fees and commissions charged by Interactive Brokers. If a quarterly management and performance fee of 1/10 with high-water mark are included then the performance for 2012, 20013 and 2014 is 21,95%, 50,80% and 25,55% respectively.

S&P 500 Propped Up by Just 2 Sectors Shows Bull Market Aging
http://www.bloomberg.com/news/articles/2015-07-27/s-p-500-propped-up-by-just-two-sectors-shows-bull-market-aging

Historical returns when the S&P is in a tight range:
http://ryandetrick.tumblr.com/post/122207942620/why-the-s-p-500-being-in-a-historically-tight

Forget car-jacking. We need to talk about car-hacking:
http://www.bloomberg.com/news/articles/2015-08-04/hackers-force-carmakers-to-boost-security-for-driverless-era

University driver becomes an Uber driver:
http://www.bloomberg.com/news/videos/2015-08-03/lessons-learned-university-president-becomes-uber-driver

The Biggest Gamble: Can Macau Beat the Odds?
http://www.bloomberg.com/news/articles/2015-07-28/gambling-mecca-macau-doubles-down-as-china-growth-slows

Sandbu vs Ford on the Greek bailout deal (FT):
http://video.ft.com/4358304620001/Sandbu-v-Ford-on-the-Greek-bailout-deal/World

How Much Austerity Has Europe Actually Endured?
http://www.bloomberg.com/news/articles/2015-07-09/how-much-austerity-has-europe-actually-endured-

Trades

Date: **July 24th, 2015**
Ticker: AAPL
Name: Apple
Transaction: Sold
Price: $125.09
Size: Exit position

Note:
Sold the remaining position in AAPL at 125.09. Having bought the position at $106, the stock appreciation was pushing the upper limits of the current valuation. I can't see the stock worth more than $140. While the company continues to grow, its reliance on the iphone is evident. Value investors have exited their positions a long time ago, and current holders have growth expectations. I believe this great American company can deliver, however it will be some time. Until then, they continue to rely on the iphone and this will bring doubt and hence volatility. This volatility I believe will present opportunities to re-enter into the stock in the future.

Date: **July 16th & 24th, 2015**
Ticker: VOYA
Name: Voya Financial
Transaction: Sold
Price: $47.76 & $46.61
Size: Exit position

Note:
Sold half the position in VOYA on the 16th, taking profit at 47.76, ahead of a potential new high. At less than 1x book and a respectable 12-13% ROE, it looks like this part advisory/investment manager (70% of business), part insurer may have some more upside. As least David Einhorn thinks so, who has been long for 2.5 yrs now.

Sold the remaining position in VOYA on the 24th at $46.61 following technical weakness and what appears to be a double top. The exit is part of a portfolio reshuffling. I don't feel I have enough clarity on the business going forward, especially with a toppish market which could affect their advisory business. Potentially lower fees would reduce returns and bring the valuation more in-line. Hence taking profit felt prudent.

Date: **July 24th, 2015**
Ticker: IMKTA
Name: Ingles Markets
Transaction: Sold

Price: $46.62
Size: Exit position

Note:
Sold the entire position in IMKTA at 46.62, taking around $1 loss per share. Having reviewed the valuation, I have altered my view on the potential upside, and the market is correct in keeping this stock at the same price over 5 months. It's fully valued.

Date: July 24th, 2015
Ticker: VLO
Name: Valero Energy
Transaction: Sold
Price: $65.30
Size: Exit position

Note:
Sold the entire position in VLO at 65.30 thus taking profit on a position with a cost basis of $55. See Commentary for my thoughts.

Date: July 24th, 2015
Ticker: ATHM
Name: Anthem
Transaction: Sold
Price: $65.30
Size: Reduced position

Note:
Sold part of ANTM at 150.80 on extended valuation.

Date: July 24th, 2015
Ticker: RS, CBI, SAFM
Size: Increased positions

Note:
Increased position in RS by 50% after good earnings at $60.03
Increased position in CBI by 50% after good earnings at $49.90
Increased position in SAFM by 50% on extremely cheap valuation at $66.86

Date: **July 15th, 2015**
Ticker: XRX
Name: Xerox
Transaction: Sold
Price: $65.30
Size: Reduced position

Note:
Sold remaining position in XRX. The market has been relentless as it continues to sell the stock since the beginning of 2015 and is now below every major moving average. More importantly, I can't really blame investors as Ursula Burns (who must be friends with Fiorina - remember her?) has done little besides reducing guidance a torturous trickle by trickle, tick by tick. Sales and operating profit both dropped in the most recent quarter, along with margins and cash flow. There is a significant lack of visibility and having followed the stock for some time, it looks like a value trap where investors are hoping things get better. I will agree that there is some historically strong cash flows, however for the stock to move up, the market will need to see some improvement that will extend beyond one quarter. As it appears to me, the best investors can hope for is a jump on some surprise earnings that I expect will be short lived. It would be better for capital to be allocated elsewhere.

Date: **July 15th, 2015**
Ticker: WRB
Name: W.R. Berkley
Transaction: Sold
Price: $56.18
Size: Exit position

Note:
Took profit in WRB at 56.18. The reinsurance segment contracted by 13% in the first quarter, and according to management things are not getting better. According to analysts at KRW, the rates may be down 10% at mid-year renewal. The stock recently rallied on the industry M&A activity. Took the opportunity to take profit.

Date: **July 16th & 24th, 2015**
Ticker: NBG
Name: National Bank of Greece
Transaction: Short & Covered
Price: $1.10 & 1.02
Size: No change position (entry/exit same month)

Note:
I entered a short position in NBG at $1.10 for less than 1% of the NAV. The rational for the trade was the drop in value due to dilution of current shareholders as a result of re-capitalization. With the banks closed in Greece and severe capital controls, the economy came to a standstill with Moody's projecting NPLs rising to 40-45% from 35%. As rumours appeared that one bank may not need the recap (implying NBG), I took my profit at 1.02. However I believe I was too cautious and should have held on.

Commentary (Continued from page 1)

Another example in Anthem (ATHM) which also beat but did not appreciate in value. ANTM has been one of my favourite positions of all-time but the valuation is extend both from a historical multiple perspective and DCFwise. A third and final example is Valero Energy (VLO). This refiner has been trending higher and higher with analysts and investors excited, however it is trading way beyond historical multiples and considering fluctuations in cash flows I don't believe using current cash flows to value the company makes sense. For Valero's valuation to work it would need either consistent cash flow and/or a multiple re-rating which is not typical of the industry. I had discussed this with my friend Kevin who highlighted that the WSJ agreed with me: "Valero, one of refining's heavyweights, now trades around 9.6 times earnings, above its 15-year average of about 8.5 times. That average is actually overstated by wild swings in 2009 and 2010 in the aftermath of the financial crisis. Take those out, and the average is just eight times, with the current multiple more than one standard deviation above that." For the full article look here: http://www.wsj.com/articles/refiners-can-keep-floating-on-cheap-oil-1437495278

Do historical valuations matter? Well apparently they do. As I mentioned in last month's letter I have been taking a fresh look at backtesting. I've been looking at single factors and models and how they drive future performance. Some of the tests have been on historical multiples and it appears that stocks trading at a discount to their historical valuations do outperform stocks that trade at a premium. So not only is it reasonable to look at historical valuations we have empirical proof that it is an important factor. Obviously, not the only one but who said investing was simple?

The study which is mostly complete confirmed previous results and once again highlighted that valuation is the No. 1 driver of future returns. The only result that surprised me was the results from backtesting momentum. It appears that momentum does not add additional return when included with other factors. This needs further study, however I have decided to suspend looking at value momentum candidates (i.e. momentum stocks that are cheap) for the time being. I am not entirely surprised by the result as having executed the FatAlpha strategy for over 3 years now, I have found that many candidates and investments from my pure value models ended up on the value momentum model. So it may make more sense to pick them up early rather than participate in the last leg of the appreciation – which is the case with value momentum.

As I mentioned above with a few examples, several companies are fully valued. In addition, "U.S. equities are being pushed along by the fewest stocks in more than 15 years" (see first article on page 3), the S&P does not perform well following tight ranges (see second article on page 3), and S&P Capital IQ is projecting a year-on-year

decline in EPS for both Q2 and Q3 which obviously does not help multiples rise. Furthermore, according to S&P, the majority of times that EPS declines y-o-y, recessions either follow or concurrently occur. While each reason on its own does not mean anything, the list is getting longer and hence my expectation for a difficult environment moving forward. In the meantime, enjoy your summer and keep in touch!