

# PARAGON VALUE STOCK STRATEGY

April 2017

## Introduction

Research indicates that investing in stocks with low or cheap valuations is a solid long-term strategy that has out-performed the stock market over time. Currently, after an extended period of out-performance, expensive or so-called growth stocks are at a valuation extreme compared to cheap or so-called value stocks. After an initial inflection point, we believe that value stocks will out-perform growth stocks in the coming years.

Paragon has developed a strategy to buy some of the most under-valued stocks, which has had good results. We describe the development and performance of this strategy in the following paragraphs. We will implement this strategy through a separate account in which we will buy the approximately 125 stocks that make up the Paragon Value strategy. We will re-evaluate the portfolio annually, so stocks sold will be subject to more favorable long-term capital gains treatment.

## Strategy History

In 1996, Paragon hired Zacks Investment Research to evaluate a proprietary value stock strategy by analyzing how the strategy would have performed over the prior 10 years. The back-test results were strong, meaning that the strategy would have outperformed the market by a statistically significant amount. However, we shelved the strategy because of concerns about timing and conflicts of interest. Ten years later, we revisited the strategy to find out how the model would have performed. The strategy would have performed quite well, so we invested our own money in the strategy in order to establish a track record based on “real money.” The investment has tripled over the last 10 years, out-performing the market and comparable strategies.

## Performance

The table below illustrates the Paragon Value Strategy returns (gross of fees) for various periods compared to the S&P 500 along with how the returns were generated.

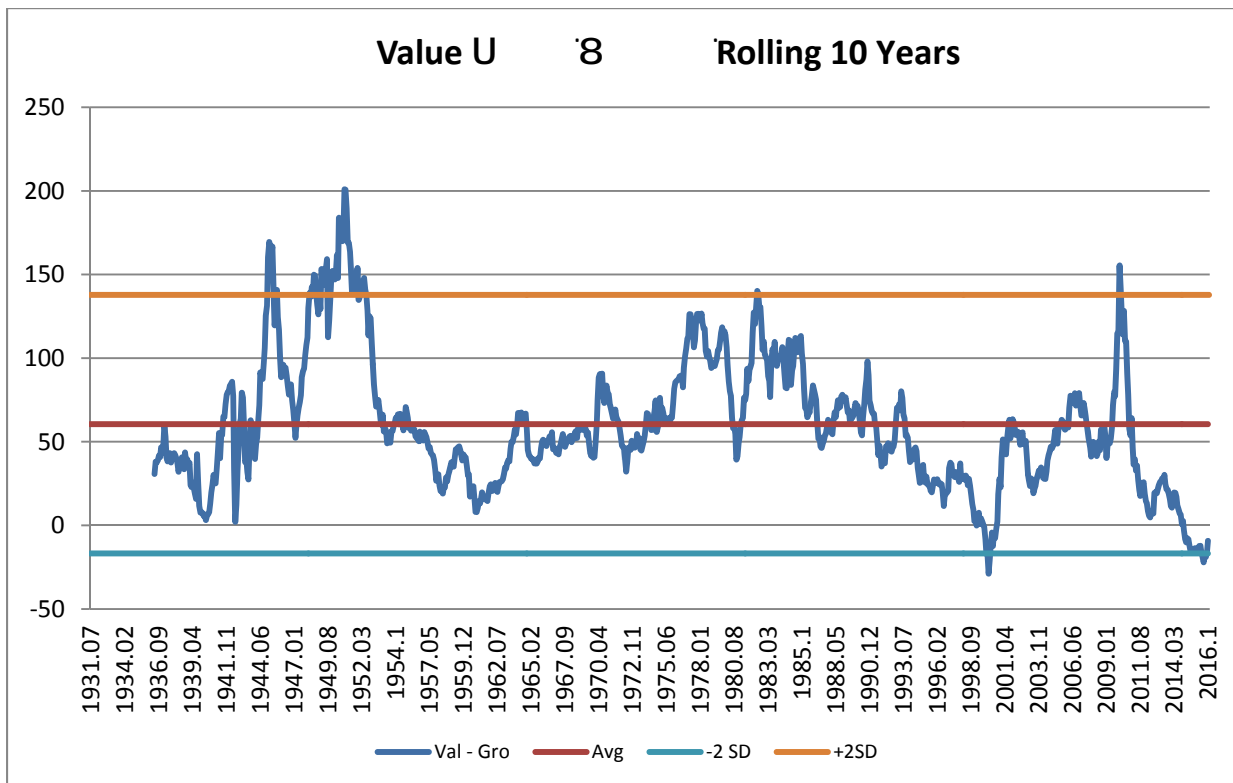
Period	Strategy Returns	S&P 500 Returns	Comment
1985-6/1996	20.3% per year	16.4% per year	Back-tested results
6/1996-2006	14.4% per year	8.3% per year	Out of sample results
2007-2016	11.2% per year	6.9% per year	Real money results

These long-term returns only tell part of the story. Risk, taxes and fees are important considerations. Also, we made minor adjustments to the strategy in 2006. We discuss these items later under the heading “Nuts and Bolts.”

## Why Now?

As we have discussed in past reports, growth stocks have been out-performing value stocks since 2008. Growth stocks are defined as the most expensive stocks, as measured by the price to book value ratio. Not surprisingly, some of the most expensive stocks such as Facebook are growth companies. However, expensive stocks can include slower growth companies that are very profitable, such as the Coca-Cola Company.

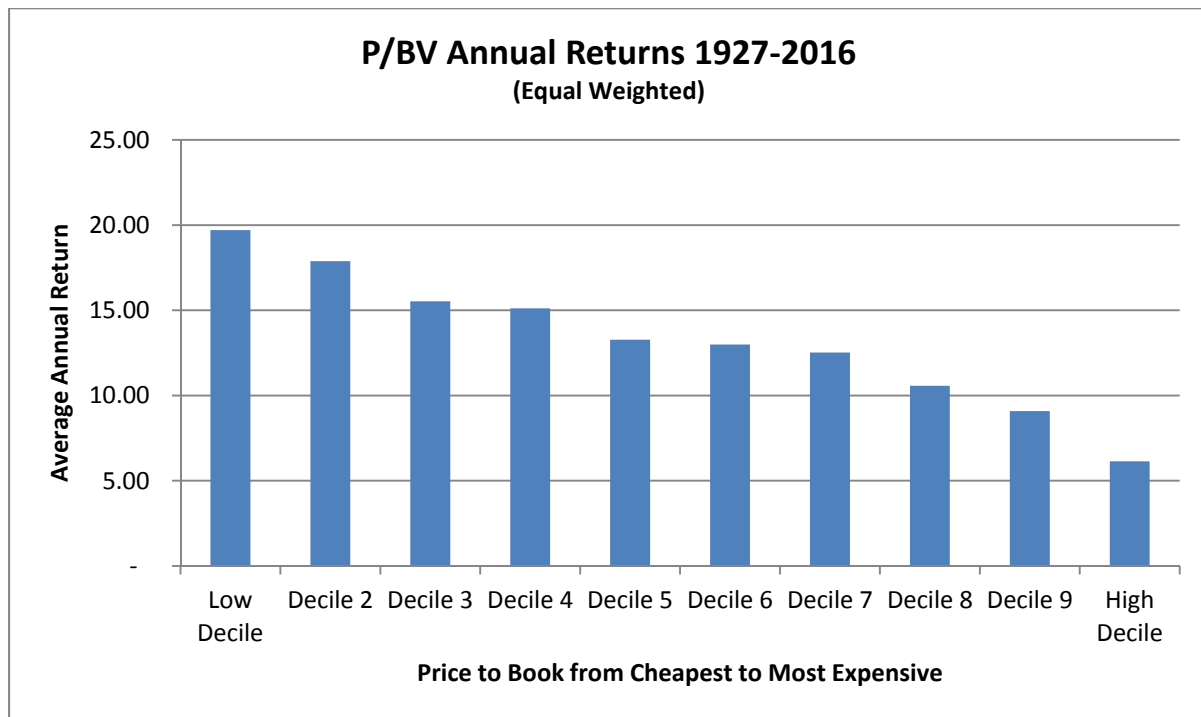
Investor behavior usually drives the long-term performance of growth and value stocks. Thus, a fascination with the potential of technology companies drove growth stocks to very high valuations in the late 1990's. More recently, the rapid growth of social media has driven a similar valuation extreme with companies like Facebook and Snapchat. In addition, residual worries from the market drop in 2008 and low interest rates have led investors to bid up companies that are perceived as safe and providing dividend income. As illustrated below, we are near extremes between growth stocks and value stocks.



The graph above illustrates the 10 year total return for value stocks minus the 10 year total return from growth stocks, for the past 80 years. The low level of the lines indicates a large amount of under-performance by value stocks; the blue line implies that this extreme would only be expected to occur 5% of the time. Finally, the out-performance over the last 6 months, which is a blip on the graph, suggests a shift to value stocks is underway.

## More about Cheap and Expensive Stocks

The chart on the previous page suggests that value stocks could out-perform prospectively, potentially by a large amount, and over an extended period. However, in addition to expecting value to begin out-performing some time last year, we also called attention to worrisome valuations for quality stocks. The chart below illustrates the average annual returns for the cheapest stocks to the most expensive stocks for the last 90 years.



## Cheap Stocks can Under-perform In Large Sell-offs

While, on average, expensive stocks represent a long-term risk of below average returns, shorter term performance of cheap and expensive stocks is more nuanced. For example, when the market was down by small amounts, value stocks out-performed, on average; however, when the stock market declined by more than 5% in a month, the cheapest stocks under-performed. The reason for these performance disparities seems to be the perception of investors. Cheaper stocks are perceived to be of lower quality and therefore, perceived as riskier. Liquidity may also be a factor. The underpinning for the long-term success of value stock investing is that investors underprice company stocks, because they perceive that those companies are inferior and correspondingly penalize them too much.

## Quality Stocks can Buck the Trend

We examined the same data as was presented on the previous page but weighted each group of stocks by the size (market capitalization) of each company stock. We found that large companies are less penalized for being expensive than the average stock. We also analyzed how valuation

affects quality stocks. We found that, although the most expensive quality stocks underperformed the average quality stock, so did the cheapest quality stocks. In short, valuation is not as useful in discriminating amongst quality stocks. Thus, in a short-term sell-off, the market gravitates to large companies and quality companies, equating size and perceived quality as defensive characteristics. Therefore, even with rising valuations for large, quality stocks, short-term downside performance may be satisfactory, and it is unlikely that moving to cheaper quality stocks will offer significant incremental returns.

### **Nuts and Bolts**

As noted earlier, we adjusted the strategy in 2006, expanding the universe from which we select stocks to include 1,500 stocks instead of 500 stocks. We also added factors to reduce the chance of buying stocks that risked bankruptcy. While the earlier periods in which we tested the strategy are not exactly comparable, the primary drivers of the strategy are the same.

The returns on page one for the strategy do not include fees; index returns do not include fees either. However, when you consider mutual fund returns, the fees as well as transaction costs have been paid by the fund. Since our real money returns include transaction costs, you would only need to deduct fees from our strategy returns in order to compare the returns with a mutual fund's returns. We have deducted 1% per year, which is approximately the average mutual fund fee, from the Paragon Value Strategy for the illustration below.

	<u>Paragon Value</u>	<u>Avg Large Cap Value Fund</u>	<u>Avg Mid Cap Value Fund</u>
Annual Returns 2007-2016	10.2%	5.0%	6.9%

Taxes are not reflected in the returns. We hold the stocks in the portfolio for at least a year, so that, when we re-evaluate the portfolio, stocks that are sold will receive the lower long-term capital gains tax rate. However, we have the ability to sell stocks if there is a meaningful loss across the portfolio. Thus, we sold stocks and rebalanced in late 2008, in order to capture the benefit of the tax losses. This action made the strategy very tax-efficient over the last 10 years. Without this opportunity, we calculate that taxes cost the portfolio approximately 10% of the return or about 1.2% per year; thus, an 11.2% annual pre-tax return would roughly equate to a 10% per year after-tax return.

As noted earlier, value strategies can fall more than the stock market in large corrections or bear markets. However, value stocks outperformed by a wide margin in the bear market that followed the tech bubble. By contrast, in 2008, many value strategies declined more than the stock market, although our strategy slightly outperformed the S&P 500. The worst relative performance by our strategy occurred in 1998 and 1999, when value strategies were out of favor compared to growth stocks. More often, recently, we have observed that sector concentration and

smaller stocks than in the S&P 500 have made the strategy more volatile, falling more in corrections and then gaining more in rallies.

The Paragon Value portfolio has a much lower valuation than the overall stock market and a higher dividend yield. We currently have 125 stocks in the portfolio, which consist of about 40% large capitalization companies and 60% mid-cap companies. A significant portion of the portfolio consists of financial stocks. Some of the portfolio characteristics are illustrated on the next page.

	<u>Paragon Value Portfolio</u>	<u>S&amp;P 500</u>
Price/Earnings Ratio	12.2	19.6
Price/Sales	1.1	2.0
Price/Book Value	1.3	2.9
Dividend Yield	3.6%	2.0%

We implement the Paragon Value Strategy through a separate account. Thus, you open an account and transfer the cash to be allocated to the strategy. We then purchase the stocks that we have identified as meeting our strategy criteria. A separate account has several advantages over a traditional mutual fund. First, you have only one layer of fees compared to buying a fund where you pay both our fees and the fund's fees. Second, many mutual funds have built in gains; that is, you are buying into a portfolio that has already appreciated and has unrealized gains. This situation can become a problem when investors withdraw large sums from the fund, because the fund is forced to sell assets to redeem shareholders. Third, if your holdings experience losses, we can sell stocks to realize losses, which you cannot do selectively within a mutual fund.

Exhibit 1: Annual Returns of Paragon Value Model (Excluding Fees) vs. S&P 500

	<u>Value Model</u>	<u>S&amp;P 500</u>
1985	37.04	31.73
1986	34.80	18.67
1987	0.63	5.25
1988	25.63	16.61
1989	25.74	31.69
1990	(10.74)	(3.11)
1991	44.03	30.47
1992	21.73	7.62
1993	13.09	10.08
1994	0.18	1.32
1995	48.15	37.58
1996	24.03	22.95
1997	35.84	33.36
1998	3.21	28.35
1999	(7.20)	21.04
2000	30.84	(9.17)
2001	15.35	(11.88)
2002	(3.96)	(22.10)
2003	36.80	28.69
2004	21.88	10.37
2005	12.65	4.84
2006	17.45	15.81
2007	1.81	5.53
2008	(34.06)	(37.55)
2009	60.52	26.45
2010	22.87	15.07
2011	3.44	2.11
2012	15.54	15.98
2013	40.94	32.41
2014	12.08	13.69
2015	0.48	1.41
2016	25.57	11.98
<b>Annual</b>	<b>16.30</b>	<b>10.98</b>

Paragon Capital Management  
Paragon Value Strategy Composite  
February 1, 2007 through December 31, 2016

As of December 31							
Year	Net Return %	Gross Return %	Russell 1000 Value Return %	Internal Dispersion %	Number of Portfolios	Composite Assets	Firm Assets
2016	24.34	25.34	10.00	0.83	3	\$742,255	\$778,038,068
2015	(0.85)	0.15	(3.83)	N/A	1	\$218,065	\$722,608,983
2014	11.00	12.00	13.87	N/A	1	\$218,341	\$706,025,611
2013	38.83	39.83	32.53	N/A	1	\$196,067	\$650,609,999
2012	14.26	15.26	17.51	N/A	1	\$140,626	\$605,006,078
2011	2.56	3.56	0.39	N/A	1	\$122,700	\$604,337,458
2010	21.03	22.03	15.51	N/A	1	\$119,001	\$600,337,000
2009	56.88	57.88	19.69	N/A	1	\$97,905	\$544,800,801
2008	(38.07)	(37.07)	(36.85)	N/A	1	\$62,186	\$498,382,723
2007	(1.34)	(0.34)	(1.43)	N/A	1	\$99,284	\$631,336,635

Annualized Returns:

3 years	11.02	12.03	6.40
5 years	16.77	17.77	13.41
Since inception	10.04	11.08	4.99

Disclosures:

- 1 Paragon Capital Management is a registered investment advisor (RIA) based in Denver, Colorado, and was founded in 1990.
- 2 The composite includes all separately managed accounts that are exclusively invested in the Paragon Value Strategy for the entire calendar year.
- 3 The Paragon Value Strategy is a quantitative strategy that invests primarily in domestic stocks that meet our proprietary criteria for value.
- 4 Returns are benchmarked against the Russell 1000 Value Index.
- 5 Gross return calculations deduct all trading costs but not management fees.
- 6 Net returns are calculated by subtracting the highest applicable fee of 1% from the gross return.
- 7 Valuations and returns are computed and stated in US Dollars.
- 8 The initial portfolio is an employee account. A number of client portfolios were initiated early in 2016.
- 9 Paragon's fee schedule is 1% on the first \$1 million of assets, 0.5% on the next \$4 million, 0.25% on the next \$5 million and 0.15% for amounts over \$10 million. All client accounts are fee-paying.
- 10 Internal dispersion is the difference between the highest and the lowest returns for each year.
- 11 Clients with significant cash flows (defined as more than 10% of the most recent value) are temporarily removed from composite.
- 12 Past performance may not be indicative of future results.
- 13 Additional information available on request.