

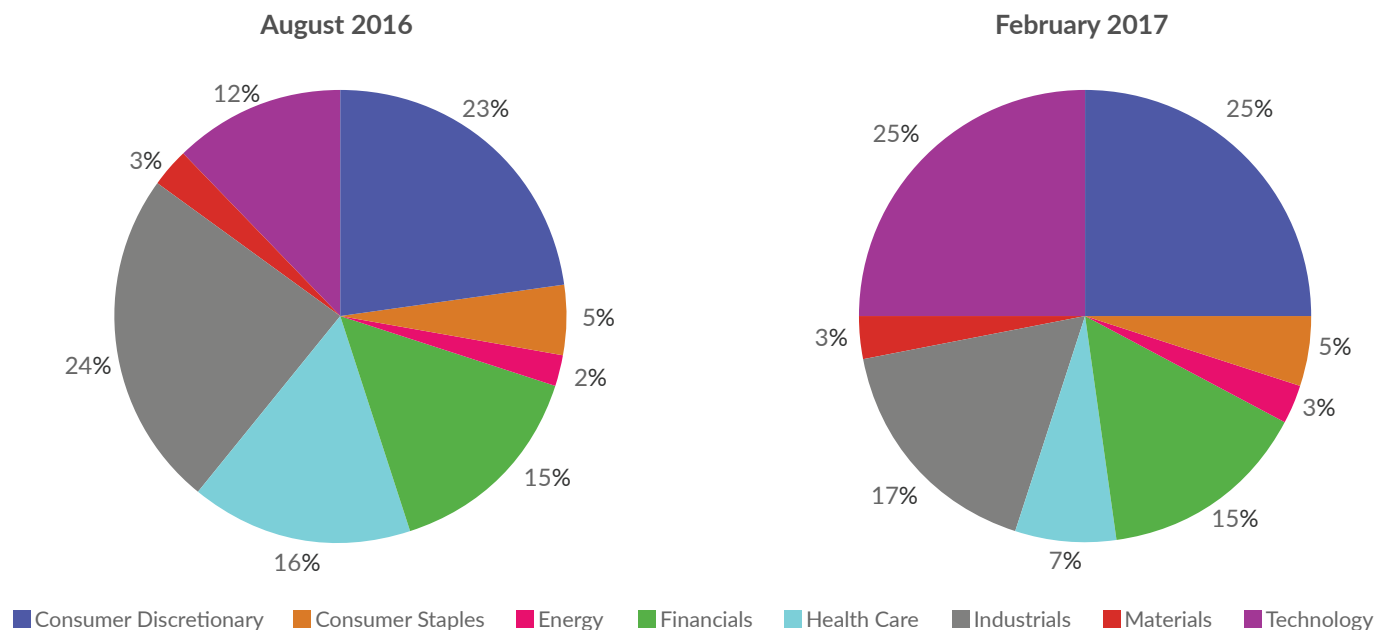
The MarketGrader 100 Index Rebalance Notes

February 2017

The MarketGrader 100 Index (NYSE: MGONE) had a busy rebalance on Friday, February 17th, replacing 80% of its constituents, after posting a 10.3% price gain from its previous rebalance date on August 19th. This was the busiest rebalance in its history, dating back to February 2003, and the busiest since August 2011, when the index had replaced 72% of its members. As is usually the case, underlying company fundamentals largely explain the index's turnover as MarketGrader's methodology scours the universe of U.S.-listed companies, twice a year, in search of the best exemplars of growth-at-a-reasonable-price (GARP), which underlies the company's fundamental analysis methodology.

Before delving into the specific company fundamentals that yielded such high level of activity (including a healthy dose of profit-taking), a few important points on the rebalance itself are in order. From a sector allocation perspective the biggest change took place in Technology, which more than doubled its exposure from 12% to 25% (13 net company additions) mostly to the detriment of Health Care and Industrials, which lost nine and seven names, respectively. And while Industrials continue to be well represented, with 17 names (17% of the index), Health Care is now represented by a mere seven names, its lowest count in four years, since February 2013, when seven companies also represented it. With its large gain of 13 new names, Technology now rivals Consumer Discretionary in terms of sector representation in MGONE, the only other sector to reach the cap of 25 names, per index rules. Figure 1 illustrates how the index's sector exposure changed from the August to February.

Figure 1. MarketGrader 100 Index Sector Allocation, August 2016 and February 2017



Source: MarketGrader Research.

In terms of size, mid caps continue to represent the biggest slice of the index, with 52 constituents, down from 53 last period, which should not come as much of a surprise to investors that regularly follow MGONE. A bigger change, however, did take place between large cap and small cap names, with the former gaining a net nine names and the latter losing eight. And while these rebalances don't quite work based on perfect quid-pro-quo symmetry, in this case with large caps actually taking the place of small caps given how many names in general changed, it is interesting that most of the size changes occurred at the top and bottom of the size spectrum, rather than in the middle, where MarketGrader's methodology seems to find the majority of constituents to its various indexes. Perhaps even more interesting is the fact that despite a larger allocation to large caps the index's average market cap actually fell from \$37.29 billion before the rebalance to \$32.07 billion after it. Yet, not surprisingly, the median market cap did in fact increase to \$5.31 billion from \$3.34 billion just last week, which goes to show that, fundamental-selection aside, it's hard to argue with math.

The GARP Effect

For those among our readers wondering how GARP actually works when selecting companies to MGONE, a closer look at the data from the latest rebalance offers plenty of clues. Before, though, a quick refresher on the role company fundamentals, as seen through our GARP lens, play in MGONE's construction: MarketGrader's standardized grading methodology, by which virtually all public companies in the U.S. are graded on a scale of 100, regardless of size, sector, industry or business model, allows us to gauge the 'fundamental' improvement or deterioration of company financials as these are reported, as well as the price investors must pay, at any given time, to own a share of any given company. This is particularly important when selecting approximately the top 2% of all companies in an economy as diverse as that of the U.S., which is, essentially, what the MarketGrader 100 Index does. More so when each company's score is built from 24 individual fundamental indicators of Growth, Value, Profitability and Cash Flow, making such standardization not only useful but also necessary.

With this in mind, it should be noted that the average MarketGrader score for all MGONE constituents deteriorates with the passage of time, from the day they are selected, to the day the next rebalance comes around six months later. This is natural as some companies report financials that fail to live up to prior grades (fundamental deterioration), while some become overly expensive as their stock price rises a bit too far, too fast relative to underlying fundamentals, even if these continue to look good (the reasonable price part of GARP). This doesn't mean that in the span of just six months these companies stopped being good companies; instead it means that making it into the list of the top 2% of companies in the U.S. requires a combination of solid growth, a reasonable price and plenty of quality (the Profitability and Cash Flow parts of MarketGrader's analysis). This is where a close look at the latest rebalance sheds some light on the inner workings of GARP as the basis of stock selection.

From the day all companies in the August rebalance version of MGONE were selected six months ago through the latest rebalance on Friday, February 17, their average grade declined by 8.0%, from 72.4 to 66.6. Such grade slippage is actually in line with the historical drop in average grades from one rebalance to the next. Keep in mind, though, that we refer to a drop in the average grade. This, of course means that overall grades fall more for some than others; in fact, for many companies the grade doesn't fall at all, which also helps explain why, historically, only 61% of all constituents are, on average, replaced at each rebalance (despite this latest rebalance high turnover of 80%). Many see their grades either rise or remain near prior levels, earning them a spot once more in the index. Regardless of their grade, however, their weight is returned to 1% at each reconstitution. So, by breaking up the old selection (from August 2016) into two groups, companies that were removed and companies that were retained, we can start to see how GARP determines index inclusion or exclusion. From that perspective it is worth noting that while the index overall saw an 8.0% deterioration in its average grade, the 80 companies that were

removed saw an average decline of 10.1%, while the holdovers from August saw an average decline of just 0.3%. In other words, the grades for the latter group, on average, hardly changed. Why is this significant? When we combine the changes in grade with the changes in price, the answer becomes self-evident.

All index constituents from August had an average increase in their share price of 10.1%, in line with the 10.3% price return of the index itself. The 80 companies that were removed during the latest rebalance, however, trailed that average return as they only gained 8.4% each. Meanwhile, the 20 holdovers had an average return of 17.0% in the last six months, not only doubling the average return of the companies that were removed but handily beating the index itself. Yet their fundamental grades hardly budged during the same six months, earning them once again a spot in MGONE, at least for another six months. In other words, their overall fundamentals not only kept up with their price gains in the last six months but also enabled them to be listed, once again, among the top 2% of all companies in the U.S. tracked by MarketGrader. The list of these 20 companies appears in Figure 2.

Figure 2. Members of the August 2016 Selection to the MarketGrader 100 Index that were once again selected in February 2017.

Ticker	Company Name	Sector	Overall Grade	Market Cap
AAPL	APPLE INC	Technology	66.56	713,265.60
ALK	ALASKA AIR GROUP INC	Industrials	63.22	11,913.68
AMAT	APPLIED MATERIALS INC	Technology	82.10	38,452.26
ANET	ARISTA NETWORKS INC	Technology	71.24	8,430.64
CBM	CAMBREX CORP	Materials	83.50	1,757.68
CPRT	COPART INC	Industrials	70.90	6,757.24
CTB	COOPER TIRE & RUBBER CO	Consumer Discretionary	69.45	2,151.80
FB	FACEBOOK INC	Technology	80.14	386,168.76
FDS	FACTSET RESEARCH SYSTEMS INC	Financials	67.71	7,212.30
FIVE	FIVE BELOW INC	Consumer Discretionary	76.48	2,180.93
GILD	GILEAD SCIENCES INC	Health Care	65.17	91,503.50
HXL	HEXCEL CORP	Industrials	65.72	4,882.59
LGIH	LGI HOMES INC	Consumer Discretionary	66.13	614.14
LOPE	GRAND CANYON EDUCATION INC	Consumer Discretionary	75.77	2,919.71
MA	MASTERCARD INC	Financials	62.02	118,283.02
MASI	MASIMO CORP	Health Care	82.46	4,221.48
NKE	NIKE INC	Consumer Discretionary	71.92	93,978.00
TJX	TJX COS INC	Consumer Discretionary	64.26	50,320.16
ULTA	ULTA SALON COSMETICS & FRAGRANCE INC	Consumer Discretionary	75.66	17,147.35
WD	WALKER & DUNLOP INC	Financials	79.99	1,182.59

Source: MarketGrader Research.

As Warren Buffett likes to say, “price is what you pay, value is what you get.” So, what did investors in MGONE in the last six months get? Forget, for a moment about the price return. That’s what they paid and, six months later, what they sold 80% of the portfolio for. In our view the best measure of the value they received is shareholders’ equity, which cannot be made up, imagined or faked. It’s what each of these businesses returned and what MarketGrader seeks to find. In the six months ended on February 17, since the August 2016 rebalance of MGONE, the 100 companies in the index delivered average shareholder equity growth of 3.1%. While this was only roughly a third of the index’s price return, it was nevertheless a solid improvement in net worth over a six-month period. Yet one that failed to keep up with the price gain, on average, suggesting some of the shares got a bit ahead of the companies’ fundamentals during the last six months. Once again, a close look at the breakdown between companies that were removed and those that remained paints a clear picture of MarketGrader’s GARP focus at play. The 80 companies removed from the index during its most recent rebalance saw a gain of just 0.9%, on average, in shareholder equity in the last six months. In other words, the growth in their net worth trailed their price gain significantly, making them

too expensive to own anymore. The 20 companies that remained, on the other hand, had an average gain in shareholder equity of almost 12% in the last six months, a remarkable result no matter how you measure it. This, no doubt, earned them a return to MarketGrader's flagship index alongside a fresh crop of companies that, once again, return MGONE to growth-at-a-reasonable-price. Figure 3 illustrates the fundamental make-up of the reconstituted index and its overall improvement relative to the August selection.

Figure 3. Select Fundamental Metrics for February 2016 and August 2016 MGONE Selections

	August 2016 Selection	February 2017 Selection
Market Capitalization		
Mean	\$37.29 billion	\$32.07 billion
Median	\$3.34 billion	\$5.31 billion
Trailing P/E Ratio		
Mean	21.5	24.4
Median	18.3	22.6
Forward P/E Ratio		
Mean	18.9	20.3
Median	16.7	19.4
Price to Tangible Book Ratio		
Mean	8.9	10.6
Median	5.6	5.1
3-Year Sales Growth		
Mean	109.8%	67.3%
Median	42.1%	29.1%
3-Year Operating Income Growth		
Mean	101.0%	46.2%
Median	67.0%	56.4%

Source: MarketGrader Research.

	August 2016 Selection	February 2017 Selection
5-Year EPS Growth Rate		
Mean	23.5%	19.5%
Median	18.4%	15.5%
3-Year EPS Growth Rate		
Mean	37.9%	31.2%
Median	23.2%	20.7%
Operating Margin		
Mean	24.2%	23.0%
Median	20.5%	19.5%
Long-Term Debt to Total Capital		
Mean	29.5%	28.7%
Median	27.9%	24.0%
Return on Equity		
Mean	38.9%	26.8%
Median	26.5%	21.3%
MarketGrader Overall Grade		
Mean	66.6	67.5
Median	65.5	65.8

Appendix

Figure A1. The MarketGrader 100 Components – February 2017 Rebalance

Ticker	Company Name	Overall Grade	Market Cap
Consumer Discretionary			
BBY	Best Buy Co., Inc.	64.38	13798.90
CTB	Cooper Tire & Rubber Company	69.14	1970.33
DHI	D.R. Horton, Inc.	67.35	11359.30
EBAY	eBay Inc.	68.08	36731.10
FIVE	Five Below, Inc.	76.48	2154.71
FL	Foot Locker, Inc.	74.50	9322.47
HOFT	Hooker Furniture Corporation	71.65	371.17
IRBT	iRobot Corporation	62.96	1481.46
KATE	Kate Spade & Co	65.91	2406.30
LEN	Lennar Corporation Class A	62.29	10950.80
LGIH	LGI Homes, Inc.	66.13	616.14
LOPE	Grand Canyon Education, Inc.	69.60	2746.26
MBUU	Malibu Boats Inc Class A	65.40	378.91
NKE	NIKE, Inc. Class B	71.92	92785.20
NVR	NVR, Inc.	75.18	7032.88
ROL	Rollins, Inc.	60.82	8003.07
ROST	Ross Stores, Inc.	73.61	26819.90
SBUX	Starbucks Corporation	63.46	81774.70
SHOO	Steven Madden, Ltd.	63.78	2191.59
TGT	Target Corporation	62.70	36403.50
TIF	Tiffany & Co.	61.76	10159.30
TJX	TJX Companies Inc	64.26	50131.20
TUP	Tupperware Brands Corporation	61.57	3044.28
ULTA	Ulta Beauty Inc	75.66	16685.90
VFC	V.F. Corporation	62.23	20846.90
Consumer Staples			
ENR	Energizer Holdings, Inc.	67.51	3314.71
FIZZ	National Beverage Corp.	71.41	2662.42
HRL	Hormel Foods Corporation	67.41	19697.90
KMB	Kimberly-Clark Corporation	60.81	43975.00
OME	Omega Protein Corporation	64.61	572.17
Energy			
AM	Antero Midstream Partners LP	80.82	6489.78
EQGP	EQT GP Holdings LP	62.87	7292.92
RMP	Rice Midstream Partners LP	67.75	2509.08
Financials			
AL	Air Lease Corporation Class A	63.48	3996.48
BANC	Banc of California, Inc.	81.26	1004.62
CNS	Cohen & Steers, Inc.	70.43	1612.89
EBSB	Meridian Bancorp Inc	67.38	1042.44
ESNT	Essent Group Ltd.	60.93	3429.99
FDS	FactSet Research Systems Inc.	68.46	7067.28
LION	Fidelity Southern Corporation	60.69	639.10
MA	Mastercard Incorporated	62.77	117051.00
NMIH	NMI Holdings, Inc. Class A	60.16	677.02
NRZ	New Residential Investment Corp.	60.84	4032.43
OAK	Oaktree Capital Group, LLC	64.12	2900.34
SGBK	Stonegate Bank	69.56	662.21
SPGI	S&P Global, Inc.	68.29	32695.40
V	Visa Inc. Class A	64.17	201047.00
WD	Walker & Dunlop, Inc.	80.21	1126.78

Source: MarketGrader Research.

Ticker	Company Name	Overall Grade	Market Cap
Health Care			
GILD	Gilead Sciences, Inc.	65.17	89126.20
GMED	Globus Medical, Inc. Class A	64.61	2562.80
ILMN	illumina, Inc.	64.36	24068.10
LMAT	LeMaitre Vascular, Inc.	76.22	438.58
MASI	Masimo Corporation	77.34	3760.13
PINC	Premier Inc. Class A	61.19	1599.65
ZTS	Zoetis, Inc. Class A	61.20	27230.00
Industrials			
ALK	Alaska Air Group, Inc.	63.22	12088.60
CATM	Cardtronics plc Class A	67.13	2007.04
CCMP	Cabot Microelectronics Corp.	71.51	1715.49
CDK	CDK Global Inc	69.62	9506.66
CPRT	Copart, Inc.	70.90	6726.20
DCI	Donaldson Company, Inc.	64.15	5597.90
HEIA	HEICO Corporation Class A	64.60	4620.28
HXL	Hexcel Corporation	65.72	4806.05
LEA	Lear Corporation	65.57	9983.63
LUV	Southwest Airlines Co.	70.99	34288.20
MIDD	Middleby Corporation	75.50	7887.58
NCI	Navigant Consulting, Inc.	60.80	1145.96
NOC	Northrop Grumman Corporation	63.59	41743.10
SPB	Spectrum Brands Holdings, Inc.	62.60	7834.05
TTC	Toro Company	66.44	6480.40
VVI	Viad Corp	71.82	967.68
WLDN	Willdan Group, Inc.	69.84	224.86
Materials			
CBM	Cambrex Corporation	83.50	1685.28
CMP	Compass Minerals International, I	62.10	2704.65
NP	Neenah Paper, Inc.	66.33	1375.93
Technology			
AAOI	Applied Optoelectronics, Inc.	64.75	583.36
AAPL	Apple Inc.	66.56	700495.00
ADBE	Adobe Systems Incorporated	68.70	58128.30
AEIS	Advanced Energy Industries, Inc.	79.06	2470.24
AMAT	Applied Materials, Inc.	81.27	38175.20
ANET	Arista Networks, Inc.	73.10	7013.88
APH	Amphenol Corporation Class A	62.27	21275.70
COHR	Coherent, Inc.	71.81	4773.05
CTSH	Cognizant Technology Solutions C	61.89	34984.20
CTXS	Citrix Systems, Inc.	62.48	12287.00
DLB	Dolby Laboratories, Inc. Class A	61.95	5044.02
EEFT	Euronet Worldwide, Inc.	62.74	4169.69
EXLS	ExlService Holdings, Inc.	60.34	1553.40
FB	Facebook, Inc. Class A	80.14	387829.00
FISV	Fiserv, Inc.	63.28	23898.00
FNSR	Finisar Corporation	60.18	3967.27
FTV	Fortive Corp.	60.90	19899.60
LRCX	Lam Research Corporation	76.39	18932.20
MANH	Manhattan Associates, Inc.	69.35	3455.89
MSFT	Microsoft Corporation	61.24	500126.00
RTEC	Rudolph Technologies, Inc.	60.01	685.45
STMP	Stamps.com Inc.	76.47	2160.49
SWKS	Skyworks Solutions, Inc.	73.38	17129.00
TXN	Texas Instruments Incorporated	71.37	75481.20
WBMD	WebMD Health Corp.	64.52	1907.01

Source: MarketGrader Research.

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p | +1.888.529.1767
e | research@marketgrader.com
w | marketgrader.com



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