

January 6, 2008

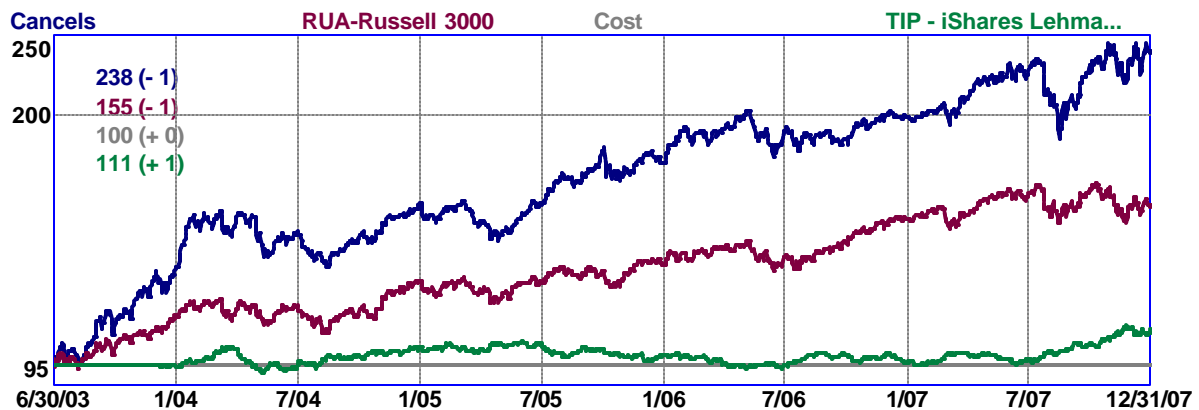


Clients,

Four major long-standing clients canceled their accounts since the sub-prime and credit crises began in August. These are experienced investors. Based on second quarter fees, they represented 27% of my fee income. All of them explained their decision as anxiety over equities. I decided to share with you some of how I am making sense of this and the implications I see for my business. I invite your feedback.

Data on Canceled Accounts

In my perspective, the short line about my job is to make the chart lines go up and not down. So I looked at their performance. Each of the four accounts covered at least the four years from 7-1-03 through 7-1-07. Their annual returns ranged from 17% to 25%; together they had an annual rate of return in excess of 21%. Russell 3000 returns for the same time period were 12%. The upper-left numbers on the chart below give a 55% total gain for the benchmark, and a 138% total gain for their accounts. On the logarithmic chart below, I ask myself at what point would I rather have the red line of the Russell 3000 than the blue line of these former clients' returns, to say nothing of the fixed income iShares Lehman TIPS Bond which has the bonus of being inflation-adjusted? Most of those who canceled said they were moving to fixed income.



Asset Allocation for Lifestyle Security

But my first response was to rethink the principles that should guide what percent of ones assets should be invested in equities such as I manage for you. This is what I came up with.

I start by defining fixed income as the total of salary and earnings from work, Social Security benefits, pension income, annuity income, any royalties, bond coupons or interest, dividends and all other interest, such as from personal loans or certificates of deposit. In other words, fixed income is any source of regular payments not coming from withdrawal of original investment or capital gains. I then decided that the sum of these fixed income sources as a percent of what is needed to support ones living expenses should at least equal ones age. In other words, the percent of living expenses coming from equity withdrawals should not exceed 100 minus ones age. Equity withdrawals come either out of capital gains or a reduction of assets.

If secure fixed income sources provide for 100% of living expenses, all remaining assets should be invested in equities or other opportunities for capital gains. This is the best way to cover the risk of inflation, and the optimum stewardship of money which will probably go to heirs or charities.

An alternative to mutual funds.

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The calculation of living expenses should include that for dependent heirs, i.e. heirs who are disabled or not able to financially support themselves. In such cases the inheritance is necessary and must be secure; it should be perceived as an entitlement rather than a gift.

Immediate annuities are a viable way to purchase a pension if fixed income does not meet the above threshold. These are available without load. A very nice calculator is available at www.immediateannuities.com. Other options include certificates of deposit (international and domestic), TIPS, and ETFs of Treasuries and short-term bonds.

Do a Monte Carlo

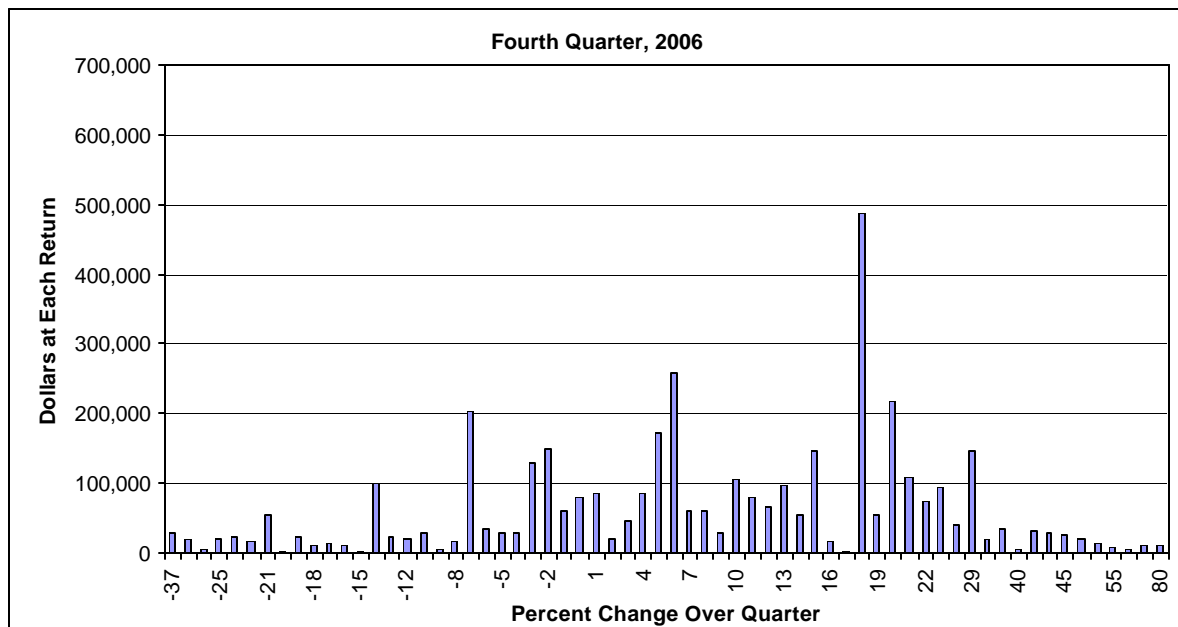
Changes in asset allocation should be based on reliable projections. Monte Carlo simulations are any projections of expenses and investment returns based on mathematical or historical variations. I would be glad to help you input your data to the point where you can explore the implications for various spending patterns and investment allocation returns. I prefer my homemade spreadsheet available at my website because it is based on history rather than an assumption that market returns follow a normal distribution.

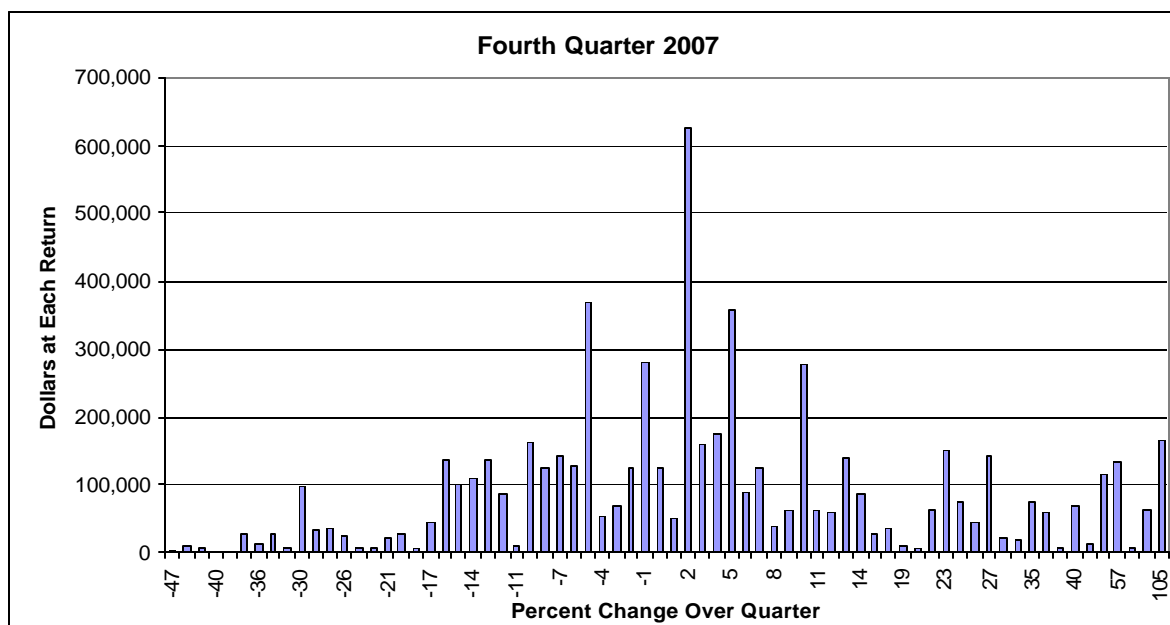
Data on changes in volatility

What about volatility? What legitimacy is there for the actions of these experienced investors?

First of all, a quick look at my overall charts reveals a major spike down in August. However, looking at where things were two months later, I'm sure glad I didn't sell into the low (except for those who canceled at the bottom).

Not only have we gone through larger ups and downs recently, but as I do your reports, it seems that different portfolios have wider ranges in their performance. Fortunately, I have moved more to ETFs for smaller accounts that are hard to diversify with stocks. To test changes in variation, I downloaded from Stock Investor Pro the quarterly returns of each position held at the end of the year. This analysis ignores whether the stock was held for the entire quarter or purchased during the quarter. Some of the data had ETFs had such as Emerging Markets and country ETFs; most did not. None of the foreign or Over-the-Counter stocks had data. The average return was 1.88%, which taken times four to approximate an annual rate comes to 7.5%, almost double the 4% actual quarterly annual rate of return. The standard deviation was 23%. The same exercise performed on data from a year earlier found an average return of 5.14% and a standard deviation of only 16%. Higher returns alone will drive up standard deviation, so the most recent quarter indeed had much higher variation. Contrasting charts of these data are shown below.





The charts need to be analyzed in light of overall differences in the two quarters, as shown in the table:

Annual Rates of Return

	Qtr 4, 2006	Qtr 4, 2007
Russell 3000	29%	-14%
Russell 2000	39%	-18%
Wenzel Analytics	40%	4%

Not only does the second chart have more and taller bars in the negative returns area, as one would expect, but the lower performing year has more and taller bars in the very high returns area. There is also a greater range of returns. Overall, we have been able to cope with the more volatile and down market by finding some very high return positions.

Go International

With so much press about the vulnerability of the US economy and the strength of the emerging markets economies, I wanted to analyze US versus ex-US exposure for Wenzel Analytics accounts. I found that Stock Investor Pro, my best data source to answer such questions, identifies companies as ADR or not, but does not have a field giving the percent of sales or earnings derived from the United States versus other countries. Many foreign ADR companies listed on the NYSE have major portions of their sales derived from the United States, and many US companies have a majority of their sales from ex-US operations. The only way I know to get at international exposure would be to go through all 280 or so prospectuses.

However, exposure to non-US currencies is a related and perhaps more significant question. Stocks purchased on foreign exchanges (2% were purchased on Canadian exchanges in Canadian currency), ADR's (23%), and country ETF's (17%) all benefit directly from the decline in the dollar. Combining these figures gives 42% of current stock and fund (ETF) holdings being in foreign currencies. If we add to that the currency benefits for companies such as 3M, Deere, Caterpillar, Donaldsons and MTS Systems which have the majority of their sales and operations outside the United States, we discover that the majority of current investments are based on foreign currencies, economies and markets. While Wenzel Analytics does not manage fixed income investments apart from what happens to be in cash or high-dividend equities, my personal allocation includes foreign CDs purchased through my bank which are paying up to 12% plus (or minus) the currency differential.

Summary of Response to Volatility

So the first response to the down spikes of the market is to ride the roller coaster back up. Rhythms are a part of life, from breathing in and out, from sleeping at night and expecting to awake in the morning, to the rhythms of the seasons. The risks of market volatility are more visible than the more pernicious risks of inflation and devalued currency, but all investing and all of life has rhythms and risks. I like the line that the only thing that goes up in a down market is the correlation between all asset classes. A second response is to find positions that go up even when the market is going down. We have several of those. A third response is to rely more on other markets and other economies. In a global world, the prudent Brazilian investor owns the same stocks as the prudent American investor. Nicholas Vardy says there is always a bull market somewhere. In the seventies it was certificates of deposit. Our fourth response is to go to cash and inverse ETFs (short) if we obviously enter a bear market.

What do the cancellations mean for my business?

Whenever I am blindsided by the sudden loss of an entire account, it is evident that we didn't have the working-together relationship I had presumed. I believe that sudden decisions to terminate all investments regardless of their respective timeframes are usually made more on emotion than logic or data.

The returns that are optimum for a money management business might be very different than those for my own account. Near the end of Ken Fisher's The Only Three Questions That Count, he proudly reveals that over the long-term, returns for the 16+ billion that he manages have been 1.7% above the market benchmark. For the last six years, Wenzel Analytics returns on stocks and funds have been 10.3% above the market benchmark. If we take an average 2% in fees, that still gives over 8%, or six times the Fisher returns. (Last year Wenzel Analytics return rates were 14% above the Russell 3000 and last quarter 18%.) Keeping clients may have more to do with low volatility than with strong returns, even if the lowest point on those returns is still above the less volatile returns. People see volatility, while probability resides in abstract numbers and calculations. Indeed, high returns might scare clients as much as low returns. At the casino, the smart thing to do after a big winning is to go home. But I don't run a casino. My niche is for people who want high probabilities of strong returns. Several clients have specifically instructed me to invest their accounts as I would my own.

I could move more into financial planning and have frequent reviews with clients to build stronger relationships. But I ask, would I then have time to do the money management? I'm already too protective of my clients' wellbeing for my own good; that would only make it worse. So I will continue to encourage you to set up an appointment to discover long-term probabilities of different returns and asset allocations on your overall long-term investments using the Monte Carlo planner on my website. And I'm available to meet or have lunch with any of you at any time, but I don't see myself moving into the role of a financial planner or scheduling regular reviews with all of you.

Maybe people just get bored with a money manager and a set of returns. They want to try something else. Fortunately, after six years of twenty percent plus returns, Jan and I are no longer dependent upon each account. New accounts keep coming, and turnover is likely to be a natural part of the game. I should get used to the idea. At some point I will want to phase into retirement, but for now I encourage referrals from you, my clients. I would also ask you to review your total allocation and see if you might not want to place more assets with Wenzel Analytics. I'm also thinking about doing more work with foundations and non-profits; if you know of such opportunities, I would appreciate an introduction.

Thanks for your business. And if you are nervous, let's talk about it. In addition to money management skills, I still have some social work skills.