

October 9, 2008



Clients,

It has been a dismal quarter. Only a few of you have called or come in for a visit. These conversations have been good. Only one client terminated during the quarter, and that was for reasons of needing money rather than because of the declining stock and commodities markets. For the rest of you, I appreciate your faith, even if you may be hanging on white knuckled or choosing to ignore and deny what is taking place with your accounts. Maybe instead of the stock market you are watching the (political) predictions market at [www.intrade.com](http://www.intrade.com).

### **Financial Security**

While it might be comforting to think that our assets have permanent and even appreciating worth, at times like this it is good to realize that all future financial security is dependent upon only two things. The first is a future market for something we have to sell, and the second is a promise that someone will pay us in the future.

What we have to sell in the future might be stocks, bonds, gold, real estate or our time and talents to a future employer or customers. Whether tangible or intangible, the ability to sell it is dependent upon future buyers who can and want to buy. What the buyer will pay will most likely be determined by the balance of supply and demand at that time. Because of the credit lockup and market pessimism, we are going through a (temporary) dearth of buyers.

If you list your house for sale and after three months you only have one very low offer, that offer doesn't define what your house is worth. If on a particular day you don't have an offer, that doesn't mean your house is worthless. Stocks are different in that every day we have a price picture, but for a day with few buyers, the price doesn't necessarily define what a stock is worth. Like with a house, sometimes we are better off looking only at the longer-term picture and only selling when we have a realistic offer.

The second security being a promise of future payments might be in forms such as bonds, insurance, Social Security, a pension, an annuity, a certificate of deposit, or a private loan. Most children are born into a family offering a network of financial entitlements or promises. Our future cash flow is dependent upon the source being able and choosing to make expected payments. With Collateral Debt Obligations (CDOs), payment guarantees were made and traded in a pyramid style outside of insurance regulation. When the first domino fell, other dependent commitments fell through as well.

So while our illusions of financial stability have been fractured, we are not forced to sell and our faith in a recovery of future markets can carry us through.

Given Ben Bernanke's background and orientation, I believe that liquidity will return to the world's banks and economies. When it does, I believe that prices will appreciate for companies dealing with tangible needs and tangible assets such as providing energy and basic materials for building infrastructure. Peak oil is a reality; it is not a bubble like momentum tech stocks eight years ago. The resource scarcity positions were hit hardest because that is where the growth and promise of high returns lie. When the credit dried up, the leveraged speculators investing in these stocks were forced to exit. I believe the survivors and those who hold on will do well.

When things are as bizarre as they have become, most buying and selling actions are based more on emotion propped up by intellectual rationalization than upon reason and probabilities. I think it is safer to ride it out. If one has ridden it this far down, one can hardly afford to get out and miss the bounce back. Maybe I'm still in denial, but I would be very up tight if I thought prices were to stay at this level

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***Lee Wenzel***

(952) 944-2699  
Lee@WenzelAnalytics.com  
www.WenzelAnalytics.com

***Wenzel Analytics, Inc.***

Registered Investment Advisor  
8666 Westwind Circle  
Eden Prairie, MN 55344

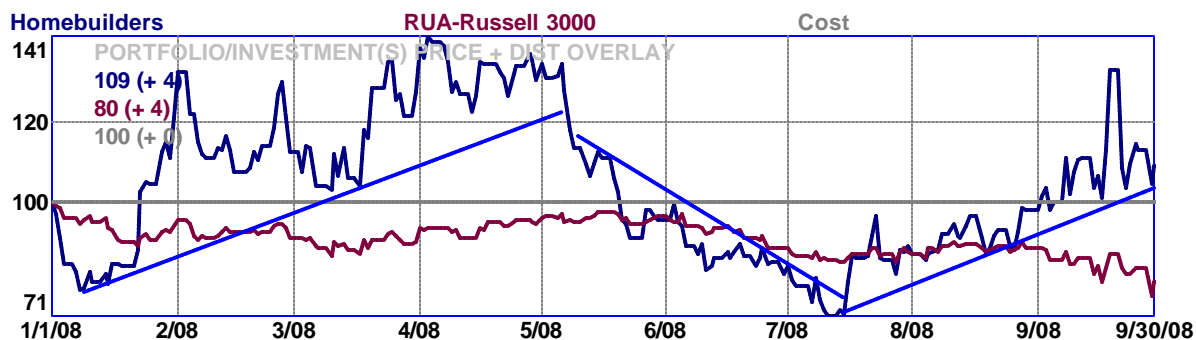
for any length of time. I just can't believe that the economic world would continue without banks lending money.

There are problems that can be solved by money, and then there are problems that can't be solved with money. The money problems are easier, especially at a macro level, because money is merely an intangible language for communicating value. Money problems are very different than a physical and tangible problems such of needing gasoline to fill our vehicles (peak oil), or roads upon which to drive. Therefore, I believe the powers that be will figure out a way to resolve the current credit crises, not that there won't be significant losers (and winners). The depth of the pricing distortions will turn the economic tables for countries, companies and many families.

### Momentum and Fundamentals

No one an island. The crises did not evolve because of any one individual or organization, but rather as a systemic interaction that then affects all banks and players. Stocks with long-term contracts and income streams, such as deep sea oil rig companies, are as affected by temporary price variations in the price of oil as are companies without the same solid fundamentals. At least in the shorter term, the price variations are more determined by global swings in speculative capital than by fundamentals such as earnings.

Janet Brown has done very well with her No-load Fund Letter buying on recent momentum. While I'm not interested in mutual funds, momentum and technical charting may have a place as one strategy. For example, I began a homebuilders portfolio in April (BZH, DHI, HOV, SPF, TOL) that I considered too risky for OPM (other people's money) with the exception of one client whose account had cash and who has asked me to do in his account anything I do in my own. For the second quarter, the annual return rate was -85%. (Back then I thought that was extreme!) I was early to the homebuilders, but stayed in. For the third quarter, annual returns were 231% ? the only bright spot in my otherwise dismal returns for the quarter. (For the Wenzel Analytics performance report, go to [www.WenzelAnalytics.com](http://www.WenzelAnalytics.com).) The third line on the first chart below has a 453% annual return rate.



If we go back a year on the same chart, February of 2008 saw a break in the down trend. July of 2008 formed a double-bottom which may confirm a reversal. So while Shiller remains pessimistic about the fundamentals of portions within the housing industry, the market is saying that the survivors have been sorted out and will come back. If one wants in, now is the time to buy before prices return to more normal P/Es.



Much is determined by the fads in where speculative capital is going. Potash Corporation (POT), the Canadian company producing fertilizer, was down -89% for the third quarter. Goldman Sachs has a sell rating on the company, believing that farmers will not have credit to buy for fertilizer for next year's crop. With the increasing demand for agricultural production, will the world let that happen? With the Goldman Sachs influence in speculative markets, the rating may be more short-term determinative than predictive. One wonders if Goldman Sachs is buying after driving down the price.

### **Interpreting the Numbers**

In reading performance reports, I would caution you that in periods of high volatility, reporting annualized return rates gives large numbers when annualizing over short time periods. For example, a portfolio down 25% over the month of September has a -97% annual return rate. In this time period, it is not unusual for positions to move 10% in a day, which gives huge annual rate numbers. Yet, I stick with the annualized rates because it is the only way to make comparisons across different time durations.

I would add that it is true that if a stock is down 50%, it has to go up 100% to get back to where it was. However, it is a fallacy to say that therefore it is more important to protect against the loss than to achieve the gains. The 50% down, 100% up comparison is an artifact of mathematical language. The comparison by itself says nothing until one includes the probabilities of a 50% loss and the probabilities of a 100% gain. Without margin, it is difficult for a stock to go down more than 100%, yet stocks can go up 100% and keep going.

While stocks and portfolios don't always form a V or even a W shaped chart, very often they do. When a stock is way down and one can rule out bankruptcy, I think of the investment as compressed and look for a bounce or rebound. And if Warren Buffet with his judgment is putting billions into a stock, such as GE or CEG, I don't think it will go bankrupt. There is more money there to help in the rescue if necessary. Sometimes we can buy these stocks cheaper than his purchase price.

### **Making Sense of Events**

I sit here and read more things than I can summarize for you. The better materials have specific prohibitions on redistribution. If you would like more depth into what is making sense for me, I would invite you to call or come in and I would be happy to listen to your perspectives, share materials with you that I find valuable, and share my thinking (and feeling).

In hindsight, it would have been better to have gone to cash a year ago and be there still. But given where we are, I think it is better to ride out the storm rather than to go to cash at this point and miss the return to more normal prices. A fairly small number of traders can have an inordinate impact on market prices. I believe 5% of the market sold their positions on Black Monday in 1987, driving down the market over 20%. It can work both ways.

Sincerely,

Lee Wenzel

Enclosures:

#### *The Perils of T-Bonds*

Most of you have either PST or TBT within a Timing/Hedging portfolio. This article is one of several forecasting higher yields and lower prices for long term bonds. PST and TBT are exchange traded funds that go up \$2 for every \$1 the bonds come down.

#### Don Coxe Conference Call

A fascinating narrative about how "Hank and Ben looked at their handiwork, and they were glad." It is one of the few explanations I have found regarding the manipulation and unraveling of commodities prices.

References:

Nicholas Vardy, [www.globalguru.com](http://www.globalguru.com), September 23, 2008

The Global Newsletter is an excellent free weekly e-newsletter about economics of what is going on in the world. The September 23 issue was about derivatives. He states "By June of 2008, the Bank of International Settlements estimated that the notional value of all outstanding derivatives hit \$1.144 quadrillion (That's \$1,114 trillion). The astonishing outstanding value of these derivatives, and the leverage they represent, dwarfs the amount of outstanding subprime loans." For reference, 700 billion is .00006% of 1.144 quadrillion. You can see why there is a problem once the defaults start reverberating and everything freezes up.

Don Worden, *The Worden Report*, October 8, 2008

Old-Man-Market is a master magician, a consummate manipulator of his victims' attention--deftly diverting focus from the relevant to the irrelevant. Have you ever seen so many experts on the banking industry and finance in general.

The truth is that unless banking has been your career, you have virtually no chance of quickly cramming enough information into your spongy brain--no matter how fertile it may seem to be--that will provide a practical insight into what is actually going on from hour to hour and day to day in the world of global finance. Preoccupation with the complex fundamentals of this credit crunch serves mainly as a diversion of your concentration.

As always, technicians know the unknowable when they see it. And there is almost nothing but the unknowable and unpredictable lodged within the mix of emotions swirling around a crisis of the type that is holding the world hostage. There is no answer to be found.

But there is a way to approach the battle. As always, a technician substitutes tactics and strategy for prediction. Markets always respond in repeated patterns. You may recognize whether the market is unhappy. But you will seldom know why. A dog may snarl and bare his teeth at you. You don't have to know what's bothering him to keep your hands out of his mouth.

The way to handle a market that actually defies description is to watch it closely. You don't have to know precisely what you're looking for. You do need to recognize changes in behavior in the hope that you can detect whether the market is up to something representing a change of mood.

For the last several days the market displayed an overwhelmingly bearish mood. Today that mood showed signs of changing...