

October 2, 2011



Clients,

After a quarter like this you are probably wondering, "What is he thinking anyway?" and more importantly, "What is he doing?"

The decline this past quarter has been significant, and worse yet, has been worse than the market as measured by the Russell 3000 or S&P 500. Our performance has been in line with the emerging markets, in which we are heavily invested either through country funds or major mining and resource companies. While the emerging market economies are thriving, their markets are not.

The U.S. market is resting at the support level it found almost two months ago on August 8, which was the resistance level of Summer 2010. We are beset by political agendas wanting to paint a precarious economy, which affects markets. The world is waiting for Europe to be tripped up by Greece and collapse. The credit default swaps on Greek debt are selling at 98%, which means the market sees the collapse of Greek debt as almost a certainty. When it happens I expect some short-term volatility, but think the risk is already priced into the markets – and maybe overly so. Rarely are the biggest threats to the markets those events which everyone has been anticipating for months.

If one believes that markets and individual stocks have price cycles like a yoyo, a roller coaster or even fractals, the time to be in is when prices are down. If one believes that markets are like a river running down to the sea, then one should exit when things are going down.

Until this year, it hasn't been that difficult to do better than the market. Somewhat in alarm, I have been intensely crunching numbers all summer to make sense of things. Since the price patterns tend to be more predictive than fundamental indicators, I have been mining weekly price patterns to develop statistically derived screens. The variables have consisted of price to exponential moving averages, or ratios of two moving averages, the exponential moving averages of price standard deviations, and the exponential moving averages of regression line slopes. Screens were developed from weekly prices of stocks in the S&P 100 going back thirty years if the stock's history goes back that far. The results were then tested on the second 100 stocks by market cap in the S&P 500. The process was then reversed, finding screen patterns in the second 100 stocks and testing on the largest 100 stocks. The purpose of this screen has been to give selling guidance and be a final test for stock purchases. The screen is right 83% and wrong 17%. A more detailed description of this research is under Papers on the website, or I would be glad to go over the work and results with you. What is interesting is that the best screen worked for twenty-nine years – until 2011! So does one presume that long-term patterns will reassert themselves, or that the world has forever changed? I have been tentatively using the screen in conjunction with other indicators, especially on selling decisions.

As consolation to trailing the index, other money managers for the first time have been having similar difficulty. MPMG, a peer with consistently the best returns I have observed, is also trailing the market. MPMG sent a letter to their clients identifying the problem as High Frequency Trading, or 60% of market transactions that are program trades made by computers. An article in *Fortune* (September 26) makes the opposite argument, saying that the high-frequency crowd limits volatility by functioning as market makers and keeping markets liquid.

***An alternative to mutual funds.***

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Jeremy Siegel makes a strong argument for equities (*Kiplinger's Personal Finance*, 10/2011, p 38) and notes that the S&P 500 does well because eight of the ten sectors sell to industrial rather than consumer markets with half their profits originating abroad. This insulates their returns from the U.S. domestic economy, 70% of which is consumer spending.

James Paulsen of Wells Cap Management provided charts showing how the U.S. markets this year have correlated much more closely with fear indexes as investor confidence is down (*Economic and Market Perspectives*). Markets are not following their normal rhythms and cycles, but are behaving more erratically based on emotional rather than analytical technical or fundamental factors. Assuming the dust will settle, the good news is that the overall market is underpriced, and specifically, a lot of strong individual positions have been bid down with their industries or sectors.

While I'm referencing authors, I would like to recommend a persuasive little book by Andrew Liveris, *Make it in America: The Case for Re-Inventing the Economy*. Liveris, born in Australia, is the Chairman and CEO of Dow Chemical. He makes an impassioned plea for how government policy and prudent business need to combine to reestablish American supremacy in manufacturing. He sees big problems in "that for every Ph.D. in physical sciences or engineering, America graduate 18 new lawyers and 50 new MBAs. This is a chronic problem and it exists even among the children of engineers." (Location 1761).

So in the making sense of things department, I have decided to clearly differentiate the prognosis for the domestic economy from the prognosis for the stock markets. Where they interrelate, I want to see how and why. To be an expert on economic matters, I want to see a Ph.D. credential. When it comes to the investment side of things, I give more credence to the CEO (I bought more of DOW last week), less to the newsletter writers, and am relying more on my own research.

We live in uncertain times. I have no way of knowing with certainty what markets will do. If there are those of you who want to step aside, with all or part of your funds, I certainly understand. An intermediate step would be to move more assets to the High Income portfolio, as some of you have been initiating. My own perspective is that if the S&P 500 drops below the 1120 level for more than a day or so, I will be moving significantly to cash. If it moves up, I will be investing the current cash levels. Personally, until your fees hit my account I'm invested at margin.

Thanks for your trust.

Sincerely,

*Lee*