

January 6, 2012



Dear clients,

Reading your individual reports shows a history of the past and your current allocation and account balances. Reading the *Performance Summary* for all Wenzel Analytics accounts gives a broader perspective as to the rationale and design for each portfolio, and a broader history and context. As an example, an evaluation of the High Income portfolio is more reliably done looking at a long history and everyone's positions in that portfolio than to look at the results of say only seven High Income positions in your account since inception a year ago.

We look at the past because we have data about the past. We don't have data about the future. But we can only influence the future and it is the future which gives relevance to our decisions. The focus of this letter is not about reporting the past or explaining it, but about perspectives and interpretations of probable futures that matter to our financial wellbeing.

A brief review of the reasons clients withdraw some or all of their money from my management reveals the following reasons:

1. They need it to live on or pay bills – which often is what it is for.
2. They die. I can't do much about that, and at least their life ran out before their money. But don't do that.
3. They are anxious about world macro-economics and volatility of equity markets.

Troubling Times

Let me speak to the third point, because all of us wonder what will come next.

There's a significant disconnect in the market between macroeconomic concerns or sentiment and individual company performance and fundamentals. Markets over the last ten years are about flat, while S&P earnings estimates for 2011 are expected to be 15% and companies are flush with cash. P/E ratios have dropped dramatically. It is a buyer's market. In spite of this, the anxiety persists. To blame it on the financial media or political posturing doesn't change it any. Clients moving their assets to fixed income aren't criticizing my performance (although it is often far short of my expectations), but are fearful of major unpredictable or black swan events. They are concerned that there is no safe place to put money, since in anxious or collapsing markets, everything tends to correlate.

It is true that things could go terribly wrong. To ignore that would be to live in a bubble. As an investor, I'm glad people worry about that because otherwise prices would be at their peak. No one would be left to pull cash out from hoarding and bid up prices. That would be the time to get out. Anxiety is an essential part of a healthy market.

As for the volatility, we have a lot of unusual volatility day by day, while over the last ten years volatility is very low. Whether that is because of high frequency trading, a high emotional level between fear and greed (which like most feelings are short-term), or some other cause can be debated. The traditional way to deal with volatility, which in financial circles is the metric for risk, is through diversification. We can diversify by types of assets, by positions within an asset class, by strategy and portfolios, or over time. In the bigger picture the bumps even out.

An alternative to mutual funds.

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

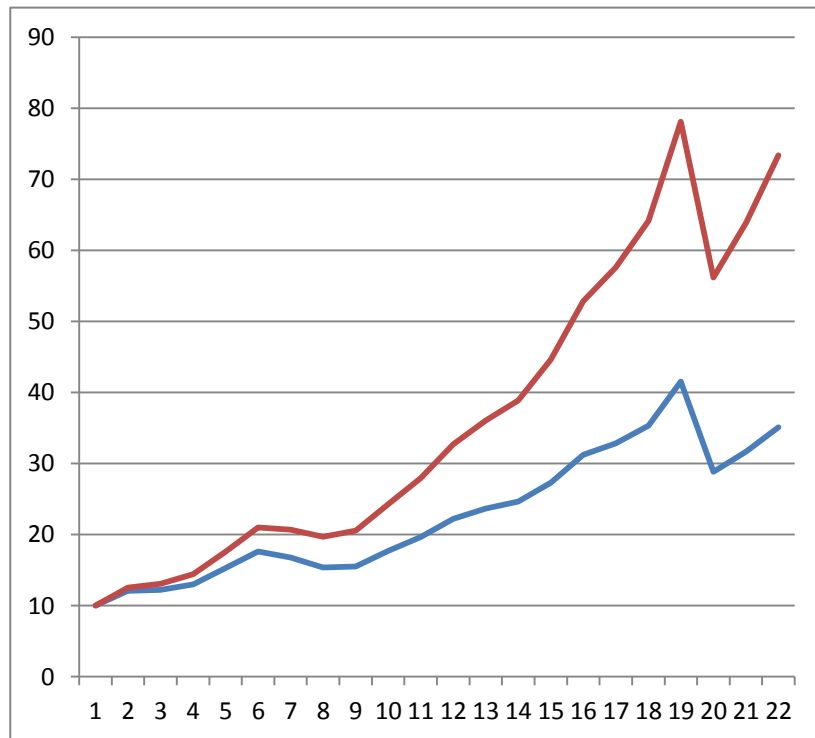
Wenzel Analytics, Inc.
Registered Investment Advisor
8666 Westwind Circle
Eden Prairie, MN 55344

But does diversification work when things are tightly correlated? Is it better to just go to something paying a steady 2% and take ones chances on inflation and the purchasing power of the dollar relative to world currencies?

To answer that question, I constructed a hypothetical example. When it comes to math or correlations, I'm not comfortable with a formula but have to see it concretely.

Both columns C and D (securities) start with a price of 10 as shown in row 2. In row 3 and subsequent rows, the preceding value is multiplied times the value in row 1 and the values in column B, chosen arbitrarily. After 22 periods (days , weeks, months), column C has only half the value of column D, yet the two columns have a correlation of .99 which is almost perfect. With the 20 degrees of freedom, a correlation of only .65 is significant for a two-tailed test at the .001 level.

A	B	C	D
1		1.12	1.16
2		10	10
3	1.08	12	13
4	0.90	12	13
5	0.95	13	14
6	1.05	15	18
7	1.03	18	21
8	0.85	17	21
9	0.82	15	20
10	0.90	16	21
11	1.02	18	24
12	0.99	20	28
13	1.01	22	33
14	0.95	24	36
15	0.93	25	39
16	0.99	27	45
17	1.02	31	53
18	0.94	33	58
19	0.96	35	64
20	1.05	42	78
21	0.62	29	56
22	0.98	32	64
23	0.99	35	73
24		Correl	0.99



The point is that even with almost perfect correlation, it is very possible to have dramatic differentiation between different investments.

Indeed, if my statistical work is accurate (and that is questionable), I found that the probability of the market over thirty years going up or down in a any given week is almost random. (It went up 51.3% of the time.) However, the amount that it goes up or down is not random and can be predicted to some degree with ratios to exponential moving averages of price, standard deviations and regression slopes over various periods.

Going back to the chart above, would you rather be invested in the red line column D with its drop from 78 to 56 or 22 points, or be invested in the blue line column C which only dropped 13 points? As in the chart, investments that end up on top tend to have bigger drops along the way.

Markets

Nicholas Vardy this week reported that of 83 economists, two-thirds haven't been this pessimistic since 2009 -- the same year the U.S. market rallied 26.46%. Except when I have a cold coming on, I remain very optimistic about the market and believe we have reason to expect a good year. Some reasons for thinking so:

1. Optimists feel better and make more money. (There are studies...)
2. Cyclical stocks are doing very well, as they do in recoveries.
3. The economic recovery is progressing very much in line with recoveries of the past 25 years (1991 and 2001). Optimist James Paulsen of Wells Capital Management notes that the third year of recoveries (coming up) is not necessarily when GDP surges, but when the cultural mindset and market sentiment change.
4. Eventually, strong company fundamentals and reasonable prices will induce investors to bid up prices.
5. There is a lot of money on the sidelines waiting to come in.
6. Unemployment claims are going down and have been inversely correlated with the stock market.
7. Consumer confidence is at a low, which precedes growth rather than recession. (Chart available)

So if markets go up, our portfolios will go up. But we want them to go up more than the market. Otherwise you would be invested in passive indexes. How to specifically beat the markets is much more challenging than the more general perception of potential.

Vardy is recommending Asian country funds. I value his perspectives in part because he is in touch with the large London hedge fund traders and has a sense of where the world's capital might be swooshing next. However, I'm becoming less sanguine about the emerging markets. Country economic growth often doesn't translate into enrichment for foreign investors. Coming off of a bad year, one doesn't want to get out at the bottom; neither do I want to continue with sub-U.S. market performance. So I will be watching closely.

For now, I'm most comfortable with companies based in the U.S. Of those, I'm most comfortable with smaller cap companies that pay dividends. The dividends have as much value for what they say about the company as for their actual contribution to total return, and dividend payers are less volatile. Over long periods of time small cap stocks do the best, and they are now the most undervalued. We can compete in that arena because there are fewer analysts and that market is less efficient. The experts with sophisticated research and big money can't get in without driving up the price or get out without driving it down. It's a competitive game and we need to choose our turf. I always ask myself, "Why am I buying when someone else is selling, or why am I selling when someone else is buying?" The transaction may be right for both of us, or it may not!

John Buckingham gave an excellent presentation with nice charts and clear data at the national AAI conference that also supported buying small cap dividend stocks. I can e-mail you the audio and handout if you would like. He gave a quote from Peter Lynch, "The key to making money in stocks is not to get scared out of them." He also noted that equity fund investors have a 3.83% annualized rate of return over the last 20 years, while the S&P 500 has a 9.14% annualized rate of return over the last 20 years. Getting in high and getting out low will do that for us.

Ten Years

The new year marks my tenth anniversary as a professional money manager. Mark Hulbert, the rater of newsletters, used to say that one needed ten years to establish any kind of statistically valid credibility. He now says it takes fifteen years, so I guess we keep going. I expect I will reexamine some business procedures and investment models, but at this point don't see anything too dramatic. I enjoy the work and find the challenge a good fit for my skills and interests. The trust you place in me is significant and means a lot to me, so thanks for keeping this going the ten years.

Lee

P.S.

Master Limited Partnerships (MLPs) are good income investments and have tax advantages. However, they also create a more complex tax return. The K-1s also often arrive after many of us have filed our taxes, requiring an amended return. Let me know if you would prefer that I not buy these for your account.

Those of you with taxable accounts should have a 2011 Capital Gains report enclosed. If you also want an electronic Excel file, let me know.