

October 1, 2012

Clients,

### **Reflexivity**

Bob Paulson used to come to the AAll investment special interest group (SIG) that meets on the third Tuesday of each month at my house. He retired as VP of Manufacturing from Maytag, and upon now retiring from investing in order to work more on his golf score, dropped off a couple boxes of books for me to go through and share with the SIG. Bob is going to limit his investing to ETFs (more later).

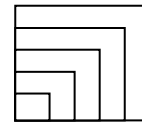
So the news I want to share this quarter is taken from The New Paradigm for Financial Markets by George Soros. Soros' real ambition is to make a mark as a philosopher. He presents as if it is rather incidental that he has made a lot of money using his perspectives and keen mind. Reflexivity is the term he uses to describe his philosophy or the new paradigm.

In natural sciences we often have cause A producing result B unless you are in to quantum physics. In the markets, and indeed in economics and all social sciences, we have result B producing result B'. We don't have a dependent and independent variable, but rather two dependent variables. It is like a dog chasing its tail. Price action is caused by evaluations and decisions about price.

For example, I may speculate that sales data are better for predicting when a stock will rise or fall because sales data are less amenable to management's manipulation than say earnings or book values. Indeed I have found price/sales (PS) a better predictor than price/earnings (PE) or price/book value (PB). But think about the circularity when we are making price judgments based on price. And sales are also affected by price to the extent that stock options are used as incentives for management, and offering new stock at a higher price means more financial resources to drive sales.

Volatility should not be a surprise when one considers the iterative nature of markets.

I am wondering if change in reflexivity is why I'm finding it harder to have market-beating returns. For whatever consolation is worth, I'm finding that mutual funds I examine as well as other respected money managers also are having trouble exceeding market returns. Like



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Bob I have considered passive investing, but I have not yet gone there.

Active investing is when I'm continually buying and selling stocks in order to exceed market performance. Passive investing is when one invests in exchange traded funds (or mutual funds) that are built on market averages or indexes. These can be balanced between a variety of markets, such as the S&P 500, emerging markets, Asia, Europe, small cap domestic stocks (i.e. Russell 2000), bonds, commodities, REITS, etc. While passive investing can be active, such as a sector rotation strategy, we tend to think of it as a buy and hold strategy, allowing the investor to go play golf like Bob and to not spend much time attending to investments.

Active investing, such as I do for you, has three handicaps in competing with passive investing. There is the management fee, or alternatively ones research time and effort. There are transaction fees or commissions. And there is normally more time in cash given the time between sales and purchases.

But for passive investing what is often overlooked is the activity within the index. Whether it is the Dow Jones Industrial Average, the S&P 500 or the Russell 3000 which I use as a benchmark, these are not static selections of stocks, but rather have significant turnover of qualifying stocks. So a buy and hold strategy of buying indexed ETFs is to buy a great deal of churning. If the index selection process is based on the value of the stocks (cap weighted), which most are, then to buy or compare to an index such as the S&P 500 or the Russell 3000 is to hook on to this reflexivity or iterative process built on the momentum or reversals of stock prices.

Many countries have decided that the volatility of this reflexivity is abetted by high frequency trading (HFT), and are commencing to place restrictions on HFT. Another antidote to the accelerated reflexivity of passive investing is to create indexes based on factors other than a company's market value. Rob Arnott publishes indexes based on factors such as dividends, sales and earnings. These tend to be less volatile and do better when value investing excels, so they are trailing during the present cycle of better returns from growth stocks.

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In April I read a persuasive case for buying small cap value stocks that pay dividends. One argument is that dividends can't be fudged for long as a measure of performance. So I selected 43 dividend stocks from the Russell 2000 Value ETF. Five months later the paper returns are double those of the S&P 500. So I have been refining a new portfolio based on small cap dividend stocks and reviewing selections from outperforming small cap mutual funds as well as stocks comprising the Russell 2000. I sorted the Russell 2000 by highest dividend and from the first 700 stocks did an initial selection of about 65 stocks that had viable charts, steady price appreciation and that met the conditions of the fractal dimension index I wrote about last quarter. I plan to be adding this portfolio to your accounts.

What struck me about going through the actual selections in an index is how many of these positions are not actual companies making something or producing a service, but are financials such as ETFs, asset management companies or mortgage REITs. So we have iterative indexes comprised of indexes comprised of indexes, accelerating the reflexivity of which Soros writes.

One wonders if there is anything solid determining value. How about Treasuries? But even there, have you been reading about how the changing collateral requirements for large banks is artificially driving the markets for Treasuries and preferred stocks? Investors are finding a market for "renting out" their Treasuries so that banks can meet their capitalization requirements, creating another derivatives market.

So welcome to the dance. Even if markets like predictability, and the Intrade Predictions Market (<http://electoralmap.net/2012/intrade.php>) bets the elections are sewed up with results not that different from what we have, it is still all a dance.

### **Future Income**

I read that the Federal Reserve is going to loosen monetary policy until unemployment declines. Back to reflexivity, what if loosened monetary policy as variable A does not cause employment as variable B? Robots and three-dimensional printers are contributing to resurgence in U.S. manufacturing. I noticed that increasingly parking ramp attendants have been replaced by machines. Tellers are quickly being replaced at checkout lanes. I went through Logan Airport recently and even the security greeter was replaced by an ethereal, flat and fully animated image talking to us.

Think Star Wars. What if more money or capital produces more investment, automation and fewer jobs unless you happen to be a good engineer?

In the future will we and our descendants be more dependent upon our investing or transfer payments of some kind, with jobs being an increasingly unreliable source of income for many people? The industrial revolution life sequence of learn-work-retire might become radically altered, if it isn't already. Look at the kids skipping school and making billions, or older people (yours truly) working because it is satisfying to be productive and connected.

With this in mind Jan and I set up an LLC to provide an income stream in part to us and then to successive generations. Even a very modest income might be critical to a grandchild or great-great grandchild. We have chosen an LLC over a trust because of flexibility, taxes and administrative costs. Contact me if you are interested in learning more about the reasoning involved and implementation details.

### **Scottrade Bonuses**

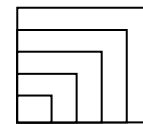
As you may have noticed, commissions are now \$3.50 instead of \$7.00. This extends through October and presumably was in return for Scottrade discontinuing the Morningstar Focus Funds which could be traded without commission.

The other bonus is that Scottrade now has an upload feature on the trading desk I use so that I can buy stocks by uploading my worksheet instead of having to key in the details of each order. When entering account numbers, symbols, share quantities and sometimes limit prices for 300 positions, this will significantly save time and increase accuracy. Accuracy is important when hitting a key twice can mean buying excess shares costing thousands of dollars, after which the stock always seems to go down rather than up.

So that means less time for the buying process and more time for research – or biking and paddling. Together with the commission discount it is also a good time to add to your accounts and tell your friends – if they are good dance partners.

I think it is a promising time to be in the markets, and I am optimistic about the tools I'm using and the resulting portfolios.

*Lee*



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