

January 4, 2013

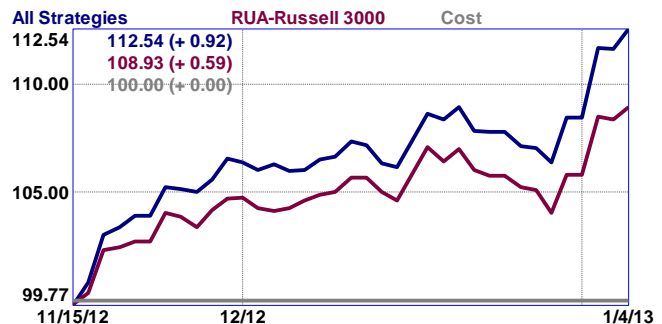


Clients,

This report will start with the more specific and pragmatic, and end with an essay on the larger economic picture as we enter a new year.

### New Understandings, Tools and Portfolios.

For many years I diligently applied my methodologies and achieved returns significantly better than the markets. Then things changed and I have been scrambling to make sense of what is going on. While I know some of you are more concerned than ever, I'm feeling that I have a better hold on things than I've had in some time. The market is turning bullish, and we are exceeding the market. Since November 15 our benchmark Russell 3000 is up 9% and the average of all 1,600 or so of our positions are up 12.5%. Today the market was up 59 basis points (in parentheses on chart) and our positions were up 92 basis points. Ok, six weeks doesn't make a trend, but bear with me to explain some of what I have discovered and am putting to work.

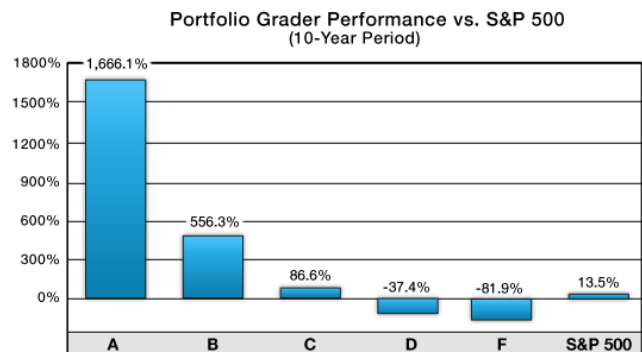


### Fractals

Markets are self-similar. That means that if one looks at a chart without labels, one cannot tell if each bar is a tick, a second, a minute, day, week, month or quarter. Smaller patterns are nested within larger patterns. The mathematics of randomness, normal distributions and standard deviations are far less accurate in describing and predicting markets than the mathematics of fractals. Markets are rough and prone to outliers. I have found a Fractal Dimension Indicator that is uncannily accurate in indicating when an up or down trend will end. It also indicates when a stock is trading randomly rather than in a trend, and indicates when a sideways or range-bound market is going to break out, either up or down. It is not a perfect tool and there is some art involved in discovering when and how to use it and over what time spans, but I have found it extremely helpful in screening purchasing decisions and in making decisions to sell.

### Strategic ownership of high quality and low quality stocks

Louis Navellier manages big institutional money and also writes several investment newsletters that have rated fairly well by *Hulbert's Financial Digest*. He speaks at all the money shows, and comes to town to speak to a ballroom full of investors every fall. I came home and went back to exploring his website which sports a grading system for all stocks. The results are impressive and the site is free. After some trial and error I found that I can grade large lists such as the Russell 1000 or all our positions and extract the results to a spreadsheet. (<http://navelliergrowth.investorplace.com/portfolio-grader/>)



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The site gives the history of a particular stock's rating, but does not allow extracting historical data for a large list. So I decided to compare his ratings to the quality ratings from the Piotroski score that I take from *Stock Investor Pro* provided by AAIL. Since Navellier has relatively few A's and few F's, I created three categories for both Navellier's grades and for the Piotroski score. The correlation within the resulting nine-cell matrix would only occur by chance one time in 1.64 if we moved the decimal 21 places to the left. So I decided it isn't too hard to identify a quality stock. Quality is evaluated by things like price/earnings, price/book value, price/sales, earnings surprises, etc. I then looked at the previous month using my Piotroski score which fairly closely matches the Navellier grade, and discovered that for the 3,800 or so stocks, the results were perfectly opposite of the market rewarding quality! There was a perfectly linear relationship, with the 0's having better returns than those with a score of 1, the 1's better than the 2's, etc. through to the 9's having the poorest returns when they were expected to have the best returns.

So that is how I discovered that the market doesn't always like quality. Indeed, markets going up more than 7.5% a year are mostly driven by low quality (or high risk) stocks. Low quality stocks are rewarded about one-third of the time. But unless one knows what third that will be, the longer term best returns are still with the quality stocks. As you can sense, I became enamored with trying to figure this out. But I became frustrated working with large data sets. So I built two indexes with about 700 positions in each, one to daily track high quality stocks and one for low quality stocks, which I now monitor. (A lot of stocks are in between.) As you can see from the charts, quality is currently doing better than the market. Is the money coming out of bonds nervous and looking for quality or "safe" investments?



### **Optimal returns in a bear market**

A third discovery of 2012 was an exploration into what holds up best in bear markets. To check this out I analyzed four-week returns from the period between 1/31/2007 through 9/30/2008. Without getting into too much detail here, I discovered that the VIX (a measure of options volatility) was the most predictive of positive returns even in a very bearish market. But rather than being a linear relationship, it has an N shape. A VIX less than 15.4 had returns of 2.3%, a VIX between 15.4 and 17.8 had returns of -1.1%, a VIX between 17.8 and 22.9 had returns of 1.2% and when the VIX was above 22.9 returns were -3.8%. Another predictive variable with linear results was price as a percent of 52week high. The higher the price or momentum, the better the results. There were other findings, and findings related to various combinations of variables, but you get the idea that here is another set of findings to use defensively that one can use profitably when not knowing if the market will go up or down – which is most of the time. If we knew the market was going down, we would go short or sit in cash. (Whether by minute, day or week, I have found that markets go up about 51.3% of the time so it is almost an even flip. The difference is in **how much** they go up or down.)

## New Portfolios

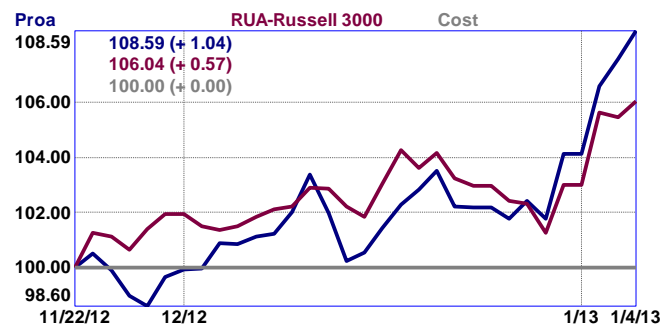
You probably noticed some new portfolios. Fortunately the cost of the turnover has been ameliorated by the half-price commissions offered by Scottrade. The savings are reported in your individual reports.

### **Small Cap Dividend**

Historically, small cap stocks have outperformed large cap stocks, although that has not been true for the past five years or so. John Buckingham of *The Prudent Speculator* made a strong case for thinking small caps will come back in favor, and that those with dividends not only provide dividends, but qualify the stronger stocks that will do better. Portfolios were selected using the indicators, grades and scores discussed above. Even if we may be early to the party, after almost a quarter during which there was heavy outflows of funds from the Russell 2000, we were able to match the market. My market-beating returns between 2002 and 2007 were mostly in small cap stocks.

### **PROA**

PROA is my acronym for Piotroski Return on Assets. This is a new statistically derived screen that is very promising based on four-week and one-year returns over ten years. A detailed write-up is under Papers on my website. The screen is in most of your accounts and so far it is working. Since the criteria were developed based on one-year returns, I plan to hold most of these positions for a year unless the Fractal Dimension Indicator gives dire warnings.



### **Navellier**

In some of your accounts I have created portfolios using the Navellier grades described above.

### **Mairs**

The only mutual fund I own is Mairs and Power Growth Fund (MPGFX), which is a distinction even if it is only 0.4% of our allocation. A recent article in *Kiplinger's* featured and recommended the fund, reminding me of my earlier reverse engineering of the fund. Owning the fund makes it easy to compare quarterly reports and see which positions are getting relatively more shares. Since the fund has only 46 positions or so and the turnover averages 3% or every thirty three years, it is relatively easy to refine a good starting buy list of the fund's holdings. Holdings are primarily Minnesota companies.

The chart is from my performance report of June, 2007. It is nice that over time we were able to beat the source mutual fund, shown here in lighter blue for a second comparison.

The annual rate of return for the five and a half years was 12.5%, double that of the Russell 3000 index. The light blue line is the fund's performance. What wasn't good enough then looks pretty good now. I have arranged for Andy Adams and John Butler of Mairs and Power to speak to our AAll program on May 16.



## The Economy

A year-end glance at our economy reveals record corporate earnings and profitability, in excess of market gains. Thus the price/earnings ratio of the market is relatively low. This commonly happens during recoveries, and is normally followed by a period of years where both earnings and markets grow, followed by a period of declining corporate profitability and continued market gains.

The most obvious fact about our economy — the elephant in the middle of the room so to speak — is that we are able to manufacture and deliver objects at incredibly low costs. Production of things is highly efficient and not the limiting factor in our economy. Supply is not the problem. The problem is in demand. Wages are low, unemployment is high and entitlements are being threatened. Where do the politicians of the right think the money is going to come from to buy goods and services and drive the economy? Will it all be exports?

The greatest productivity challenges are in healthcare, education, employment and retiring baby-boomers. Engagement, or lack thereof, is the defining issue in all four areas.

We spend far more than any other country for healthcare, yet measures of health status are only middle of the road when compared to other countries. We rate well in the “do for” categories of acute care medicine where we are passive patients of someone “treating” us like objects. We rate poorly when it comes to chronic health conditions requiring engagement and “do with”. Much of this has to do with the inherent influence of insurance as a mode of payment.

The Affordable Care Act appears to introduce two major systemic innovations: Insurance Exchanges and Accountable Care Organizations. Insurance Exchanges are an exercise in futility. Once individual underwriting is removed, it is no longer insurance. The focus is on benefits rather than medical services delivery. The Exchanges engage people in plan design but not in health care. The evolving Accountable Care Organizations will exert a more profound systemic impact on the delivery system. They open the door for more collaborative engagement in impacting our own health. The economic opportunities are in products and services that help people take responsibility for their health, whether paid for by individuals or the newly aligned Accountable Care Organizations.

Education is another large complex, sclerotic bureaucratic system that is not producing adequate skills to be competitive in the new world economy. Having come from a one-room country school, to me the system seems too focused on teaching and not enough on learning or engagement. As in medicine, the system is too focused on doing for rather than organically nurturing attention. The industrialization model and mass production work very well in manufacturing, supply chain logistics and mass marketing. We are still finding our way in how to apply mass production technologies to enable needed engagement in both health care and education.

Unemployment is a drag on economic productivity. Long-term unemployment is a huge problem for many and impacts all of us through the effect on our whole economy. What if low interest rates as provided and assured by Bernanke’s Federal Reserve are no longer correlated to employment? One issue under the crises is that many people are actively looking to be passive recipients of a job offer when they should be looking for work, not a job. The issue is engagement. How can people engage themselves in productive activity that provides economic remuneration? Is employment becoming less relevant in the new economy? Can people and organizations work together more productively outside of an employment contract?

For many baby-boomers, the distinction between unemployment and retirement is subtle and often entirely semantic. Many need an income. Even those who don’t have an economic necessity to be productive may not find fulfillment in being occupied solely with talking about trips, golf scores and medical issues. Is there a business model that provides services for this unmet market?

What are the successful business and economic models for engagement? The dominance of Apple Inc. can be attributed to employee engagement and how their products engage the user. While I'm told that it is easy to become engrossed in Apple products, the products are criticized for having limited flexibility to engage the more demanding consumer. The success of social media is all about engagement. Personally I soon found Facebook to provide more information about more people than I wanted to know, although that didn't stop me from buying the stock which is up 35% in the four months I have owned it.

The disconcerting part of this analysis is that my business model is primarily a "do for" rather than a "do with". The nature of the task doesn't lend itself to a lot of joint decision-making. Even the plan for you to choose the portfolios and I then choose the positions doesn't work very well in practice, as the merits of specific portfolios ebb and flow and I like the flexibility of retiring some portfolios and finding or creating new ones. For example, I assumed that the High Income portfolio would be the least volatile and this past quarter it had the most volatility and lowest returns.

One implication of a "do for" model, whether that is in healthcare, education or my business, is that success is measured by outcomes. That may seem reasonable enough if we could control all the variables. But sad to say, mortality amongst medical patients is running at 100% longer term. In investing the more certain we try to be about the outcomes, not only are the returns lower but we are more traumatized by the surprises. Not only can we not control the outcomes, we can't even predict the probability of an outcome since markets and returns follow fractal patterns rather than normal probability distributions. In investing, risk is a concept measured by volatility or standard deviations. Markets are not as orderly as implied by a concept of risk or normal distributions. No wonder people are frustrated by returns that do not meet expectations. Yet, the secret to success is in working to understand the fractal patterns and in riding those that are going in favorable directions. Success comes from flowing with, from engaging in the dynamics rather than in resisting. Clients who cannot bring themselves to flow with the undulations are kind of like the long-term unemployed looking for a job that is hard to find, or the person with a chronic illness looking for the doctor to fix things.

Outcomes relative to markets are a valid measure of performance and making decisions about how to manage your money if you look over a five and preferably a ten year period. Shorter time frames are like evaluating Minnesota weather by taking the average for any given month. It doesn't give the whole picture. You and I both attend to returns, but what is very important, is to weigh returns relative to appraising the methodology. It is the mix of methodologies that produces returns in excess of the market over time. I invite you to discuss methodologies with me to whatever level of detail is of interest to you.

One level of engagement I provide is a greater transparency of reporting than most any other option available to you. Perhaps more than you want to digest, but it is there for you. Mutual fund companies report the returns on a given fund, but when a fund does poorly the fund is merged with another more successful fund. The poor performance record is thus erased. Returns are given for specific surviving funds, but not for the whole family of surviving and terminated funds. Few money managers of any kind, whether they be fund managers or financial advisory firms, report returns on their entire book of business.

*Lee*