June 30, 2013

Wenzel Analytics Inc

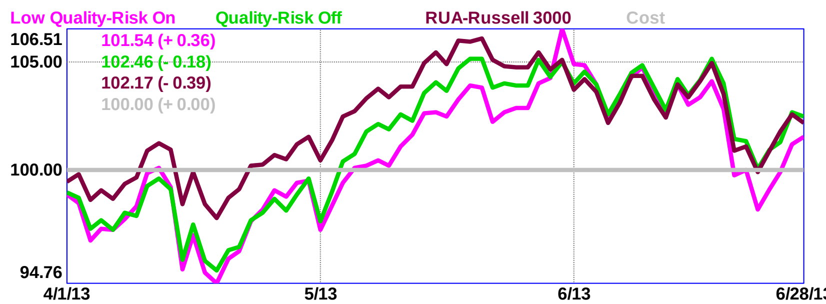
Clients,

My expectation is that I should be able to consistently beat the market by at least two percentage points after fees. We are not doing that.

**What is going on?**

The fact that so much is random from quarter to quarter and from portfolio to portfolio makes it easy to overlook, deny or excuse longer-term trends. And as for what we read in the press, the more we know the less credible it seems.

For example, I read in the *Economist* (June 15, p72, Buttonwood) about a move to quality defined as equities "that pass a series of financial tests known as the 'Piotroski F-Score.'" The article goes on to describe all the reasons for, and the implications of, this move to quality. Well it happens that I have created indexes using the Piotroski F-Score and daily monitor high quality against low quality stocks. The chart to the right shows how high quality and low quality stocks compared to the Russell 3000 for the last quarter. As you can see both high and low quality trailed the market for most of the quarter. Then they caught up and matched for a while, and ended the race with low quality trailing slightly. Historically, high quality does somewhat better, but not necessarily overall as low quality can really jump in bullish markets. The point is that it's not easy knowing what is going on. There are lots of opinions, and there are lots of numbers that statistically are noise rather than signal.




**So how are we doing?**

On January 1, 2002, I began managing money for other people in addition to my mother. Annual returns over the next 6.5 years were **12.5%** compared to **4.3%** for the market. This business is a piece of cake, I thought. All was going as it was supposed to. Then came the severe decline of 2008, and sad to say the accounts I managed went down about 50% or the same as the market. Fortunately, we stayed in the market and returns from the March 9, 2009, bottom through 2010 were 41%, about the same as the market.

Since the start of 2011 our returns have trailed the market and I'm trying my darnedest to figure out what is different. There are periods where the lines are parallel, and there are portfolios which occasionally beat the market handily, but the truth is that we haven't had portfolios that consistently beat the market by a wide margin. Efforts to become more aggressive, such as in international ETFs, resource scarcity stocks, and very high dividend stocks have so far made the problem worse rather than better.

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**Is it just me?**

While it is easy to blame myself, I don't think the problem is my skills, choices, knowledge or tools. I'm working harder than ever, have learned a lot, and have better resources. I have had clients leave and I support them, given the results we have had. One then invested in five-year bonds at about 1%. I haven't had any that I know of that have gone to places where I would want to invest, or services that would fit in our business goal of consistently beating the market after fees by more than two percentage points.

From what I read, active managers are increasingly tracking their respective indexes or benchmarks, but not by enough to cover their fees. (Blanchett, "Are Active Mutual Funds Becoming Less Active?" in *Journal of Indexes*)

The American Association of Individual Investors (AAII) publishes 68 screens or sets of criteria for picking stocks in order to get exceptional returns. If you look at a chart of performance relative to the S&P 500 since 1999, there has been a steep decline in market-beating performance. The years 2009 and 2010 were exceptions, but a look deeper finds results skewed by screens with only a handful of selections and inordinate gains. (Chart and details coming to my website.)

Are the *Hulbert Financial Digest* newsletters able to beat the market? If we ignore the sub-portfolios and only look at each newsletter overall, of the 202 newsletters in the latest report 19% had 2012 returns in excess of the Wilshire 5000 benchmark. And this is without management fees. Eight percent of the newsletters beat the benchmark over both the last year and the last five years. Six percent of the newsletters beat the benchmark over the last year and since their inception. Those aren't very good odds. Why aren't half beating the market and half trailing?

**So what is causing the problem?**

I attribute the problem to fundamental changes in the equities environment.

1. Individual investors have largely left the market.
2. I suspect that High Frequency Traders (HFT) that are going broke in the nanosecond trading business are applying their technology to longer-term trades. Why wouldn't they? Ten years ago, my spending a month data-mining with 500,000 rows of data provided a competitive advantage. Today, I expect the use of far larger databases with far more sophisticated analyses and consequent trades made automatically second by second. The average turnover of any given stock has gone way up.
3. The market is dominated by indexes.

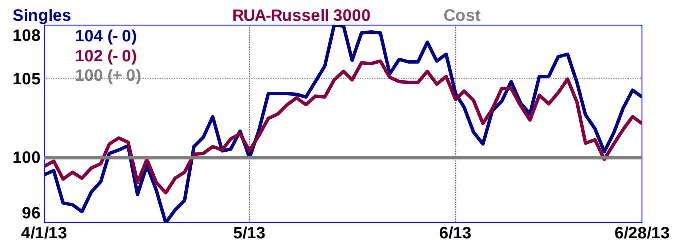
In analyzing who is bidding in this auction we call the market, the distinctions between these three categories becomes blurred. From what I add up, something over 70% of all market trades are by ETF or mutual fund indexes, or money managers closely aligned to track a specific benchmark index. Bogle and Kiplinger actively promote indexed investing, since it is so difficult to beat the market. Some congressmen have even proposed it as part of a required pension system. Indeed, if we can't beat the market, why shouldn't you lower your risk and expenses and become a passive investor?

Think a minute about the iterative nature of this, the problem of the commons, and where this is taking us – if it hasn't taken us there already.

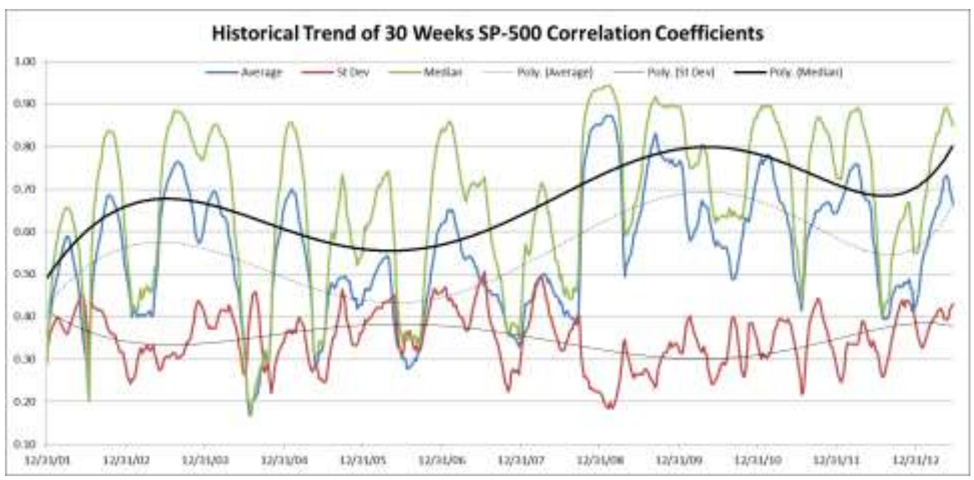
Let me explain the term "problem of the commons." When the Boston Commons – today a nice park for swans and strolls – was a pasture, the residents learned that if they put more cows on the Commons they would get more milk. That worked until it didn't. Many things that make sense at the individual level don't make sense at the macro level, which is why we have micro and macro economics. Climate change is a problem of the commons writ large.

So if we all buy indexed ETFs, when that money comes into the market it buys up all the stocks in that particular index, usually based on the weight or capitalization (shares times price). So every stock of the same size gets the same buying (or selling) pressure. If the stock manages to get bigger, it gets even more buying (or selling) pressure. So we no longer have an auction based on the individual merit of a stock, but rather "socialized" buying and selling. The more indexes to which a stock belongs, the more pervasive the effect. In fact with some 900 ETFs now, it might be easier to buy a stock as a way to buy into multiple indexes rather than to buy an ETF as a way to buy into a basket of stocks. If we all buy an index, what is left to control the merits of individual stocks?

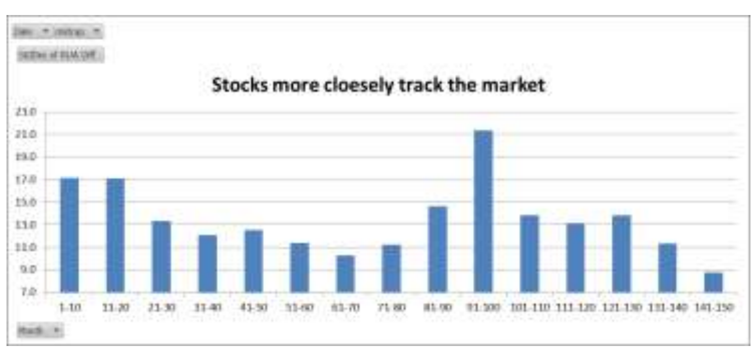
I have five stocks in a Singles portfolio for one of you. The stocks are AIG, Amazon, Costco, Lennar Corp (a housing builder), and Stratasys (three-dimensional printers). These are only five companies, very different in very different industries. I think they are each above average companies with strong potential. Yet, look at how closely their prices tracked the market this past quarter. Does that look random to you?




I have been doing research on the correlation between stock prices and market indexes which I will post on my site. To give a sample, here is a chart going back to when I began this business. For each week I did a correlation over the previous 30 weeks (in this case) of each stock with the index (in this case the S&P-500). The chart shows the average, median and standard deviations of these correlations. The smoother lines even out the bumps (although it is amazing how even the bumps match for different indexes and correlations). Correlations between stocks and between asset classes always go up when prices go down and panic sets in, so the rise in 2008 and 2009 is not a surprise. But correlations are at that level and going up, and we are in a market that has been going up since 2009.




Correlations would not be a problem if while all stocks moved in sync with the market, they went up more when the market went up and down less when the market went down. Indeed that is the dynamic for stock gains. The issue may not be the correlation, but that the amount of movement up or down so closely follows that of the indexes. While I analyzed this from many angles, let me show one chart of standard deviations of how much stocks varied



from the market price. While stocks were more independent in pricing during the 2008 collapse, the present level is the lowest it has been in twelve years.

I don't know where indexed buying is going, but I don't see it turning around soon. I think a lot of people have their head in the sand.

**So what is to be done about it?**

To those of you who have read this far, I will announce that I have lowered my fees in order to make it easier to give you better returns net of fees. My fees changed from .4% plus $80 per quarter to .25% plus $50 per quarter, beginning April 1. (The first several years my fees were .5% plus $100 per quarter, but I needed it more then and mutual funds were also charging more.) If we have a couple years of beating the market by a wide margin, no one will care if fees go back up.

Another option is to change the business premise. Should I be like most financial advisors and minimize the importance of performance, while focusing more on the benefits of diversification and defensive allocations? Even if we all go to indexed ETF investing, one still has to select a balanced set of indexes and there is still the matter of getting out and in when faced with market turns.

Another alternative is to try to avoid the impact of indexes by buying micro-cap stocks. In general, they don't do well in part because they don't have the market demand created by all the money coming from indexes. IPO's are down, some say because of Sarbanes-Oxley. Could we find the few that will become a Google, Netflix or Microsoft?

Another alternative is to buy companies traded over the counter, which is something I generally avoid. Personally I have thought about buying companies not publicly traded - not easily done with IRA money.

Meanwhile, I will continue with trying to figure out the markets and managing your accounts. Some of you will stay with me and some of you will not. Really, the issue was not a crisis until I made it so in my mind. Maybe the nature of the markets will change, or I will find the Holy Grail. Stay tuned. What are your thoughts?

On a more immediate note, I expect the market to go up for a couple weeks, and then take a serious correction. I don't think it will be like 2008 and 2009, but it could well be 20%. Except for gold, I'm prepared in my mind to go more to cash than I ever have before, perhaps for as long as six months. Let me know if you don't want to go on that ride.

Sincerely,

*Lee*