

October 2, 2013

Clients,

Portfolio Management and Performance

Around July 18 almost all portfolios were sold with the exception of portfolios for gold and silver, the high-dividend income portfolio, and a few resource scarcity stocks. So we have been 71% in cash since then. Overall performance since then has exceeded the S&P500 while only slightly trailing the Russell 3000, and this with much less risk or volatility.

Market Research Perspectives

Last quarter's letter spelled out the destructive impact index funds are having on the market. If two thirds of the bidders at any auction are holding the money in their pocket with instructions to buy at any price, I believe that is going to distort the auction. While I have not changed my perspectives since three months ago, I have learned a lot and my mood has improved significantly.

One thing I have learned is that very few if any investors want to hear what I am saying. No one argues with me, but I believe the implications are too significant to absorb and unseat fundamental beliefs.

It has occurred to me that capitalism depends upon the markets for the efficient allocation of capital towards productive enterprises. If all stocks in an index are bought by index funds independent of their individual merits, capital is no longer being channeled towards the most productive firms. Also, rewarding executives with stock options makes little sense if management is not a primary factor driving stock prices. While these are significant macro-economic concerns, most of my work has been at the level of figuring out what to do in response to the presumed dynamic of indexes dominating markets.

As you know, I have been enamored with fractals. XLQ is an Excel add-on developed by a software engineer in the Netherlands named Leo van Rijswijk. Over 300 variables such as current or historical prices, moving averages, stochastics and many others, can be imported and analyzed by writing the proper formula in Excel. I sent him a page of computer code I found in an article by a biometrician from Caracas and asked if he could incorporate a Fractal Dimension Index in XLQ.

An alternative to mutual funds.

C:\Users\Lee\Desktop\WA\Client Files\Client Ltr 2013-Q3.docx, 10/2/2013



The answer was always "Maybe when I have time." I tried to send a \$100 gratuity, but his website order form was only for specific products. Finally his website vendor gave me a special link and I was able to send my gratuity, and what do you know? His work was exceedingly thorough and conscientious and I now have a Fractal Dimension Index in Excel!

I have been analyzing two years of weekly data on over 4,000 stocks, as well as ten years of monthly data on the same stocks. My hypothesis has been that most stocks are controlled by indexes most of the time, but not all stocks all of the time. As I presumed, much higher returns come from stocks more volatile than the market. The Black Scholes formula used in pricing options is based on the premise that volatility has more persistence than price. Analyzing about 400,000 rows of monthly and then weekly data, I discovered a set of criteria that gives more than four times the returns and works one month into the future, one quarter into the future and one year into the future. What is exciting is that the same five variables at roughly the same values worked almost as well for weekly data as they did for the monthly data. So what worked with monthly data over ten years also worked over two years with weekly data. All of these findings are at a level of significance greater than .01 and most greater than .000001. Of course there is survivor bias. If you are interested, the variables include a coefficient of variation (standard deviation of price divided by moving average), thirty-period and six-period standard deviations of past returns, price and the Fractal Dimension Index.

I will continue to refine these findings so as to be used in three ways when the markets appear safe for reentry. The first usage is to screen for the two percent of stocks that meet the five criteria that gave returns more than four times that of the market. This will be one portfolio. The second usage is to use less stringent criteria on proven portfolios such as we held before going mostly to cash in July. The third usage is to refine the flip side and look for the inverse of the screen criteria as an indicator of when to sell.

If you are interested in any of the technical aspects of this research, I will be happy to share that and discuss it with you.

Lee Wenzel

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

Wenzel Analytics, Inc.

Registered Investment Advisor
8666 Westwind Circle
Eden Prairie, MN 55344