

July 2, 2014



Clients,

We just emerged from an exceptional quarter. Returns on the Wenzel Analytics book of business were up 4.2%, which if continued for a year would be 18%. See the *Performance Summary* for details and perspective. It may prompt you to give me specific guidance as to your desired allocation between portfolios. As always, some of your returns were above the average and some below; sorry if your account was in the latter group but next quarter it may be reversed.

### **Markets**

The major market indexes have been moving up into a tighter and tighter wedge for the past year. Usually such a pattern precedes a breakdown, which was expected long ago and could be yet awhile. The small-cap Russell 2000 has had more volatility, and is sitting at the top resistance of last March. If you look at the quarterly returns for the benchmark indexes on page 4 of the *Performance Summary*, you will see that there has been considerable variation between the different indexes or markets.

On Sentimentrader.com, Smart Money confidence is at 29% and Dumb Money confidence is at 71%. A spread of 40% or more usually portends a break. My fractal guru, David Nichols, thinks we could be near a top, and that whatever happens the last half of July will probably be with us through October. This last week I was working on my buy list for the PRS portfolio and couldn't find any stocks that I would buy. That is usually a sign of a market top.

I have no doubt that we will see a correction. The question is how severe it will be, and to what degree should we ride it down and back up, or exit positions to a certain extent. After my last experience in preemptively going to cash, I'm more inclined to mostly ride it out until things look more severe, i.e. greater than 10%.

The correlation level between S&P-500 stocks is down. That alone makes it more likely that some holdings will be somewhat immune to market swings. In addition, I have been making selections based somewhat on market independence. The next step is to go more specifically into lack of correlation by evaluating the number of days each stock went down, and the degree, against a market benchmark such as the S&P-500 or for specific profiles, such as value stocks.

### **Investing**

I'm feeling more comfortable and solid with strategies and portfolios than I have for a while. I'm more committed than ever to systematic investing, meaning to invest by rules or screens rather than stories. The solid, core portfolios are the High Income, O'Shaughnessy and Piotroski Relative Strength (PRS). The Shadow and Investment Advisory portfolios are there for when more risk is desired. The gold and silver allocation will stay where it is for the foreseeable future. SectorSurfer at [www.sumgrowth.com](http://www.sumgrowth.com) is still too good to be true, but very intriguing. The other two statistical screens based on fractals and coefficients of variation are on probation.

I plan to reduce the number of portfolios in each account, and put more positions in each portfolio. Insurance also uses the laws of large numbers, but it is used in the opposite direction. Life insurance will predict a mortality rate, but not try to identify who it might be. Samples are used to make conclusions about a population. Here we are analyzing the population, and trying to make inferences about what will happen within a relatively small sample. So we need samples large enough to represent the population.

***An alternative to mutual funds.***

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## The Business

While long-term returns are excellent and are matched by very, very few money managers, the lower returns of the last couple years have caused some client attrition. I'm old enough that it is nice to have fewer reports to write and less complexity to manage. At the same time, I feel like a turnaround has happened, and I'm okay with that. I'm seeing new clients.

David Brooks had an illuminating editorial June 30, *The Evolution of Trust*, about the peer-to-peer and sharing economy replacing trust in institutions. [www.nytimes.com/2014/07/01/opinion/david-brooks-the-evolution-of-trust.html?\\_r=0](http://www.nytimes.com/2014/07/01/opinion/david-brooks-the-evolution-of-trust.html?_r=0). The editorial gave a framework to my business model which from the start has been independent of financial institutions to the greatest degree possible. Mine is a personal business in an industry which is embarrassingly ruthless. I'm amazed at what people will do for money, even when they don't need it, or should I say especially when they don't need it. Reading *Flash Boys* by Michael Lewis only increased my paranoia. The book is a fascinating read, and I recommend it even if you have little interest in high finances.

Thanks for trusting me to manage your money. If you ever want to get together or have lunch to talk about whatever, let me know.

Sincerely,

*Lee*