

September 30, 2014



Clients,

## Markets

The large-cap stocks of the S&P 500 have been booming until lately.

While the ascending triangle looks nice, technical analysis finds that such charts “break out” when the point of the triangle gets too tight. Fractal analysis also finds that when trends get too tight they break out.

Looking at the same three-year period in a larger context reveals the tightness of the trend, as well as durations of such trends.

Given typical retracements of 38%, one might expect a correction (by February?) to 1,740 for

the S&P 500, as shown by the horizontal line in the first chart. That would be a correction from the high of about 13%. Maybe I’m getting old and bruised, but I’d rather not take that kind of a haircut. Looking at the longer-term second chart, a correction to 1,550 and the highs of 2000 and 2007 (down 22.5%) over the next couple years is very possible. After that retesting, the continuation of the secular bull market would be more promising.

There are other indications of a top in the market. I have had trouble finding stocks that meet my criteria when trying to replenish current portfolios. The number of stocks in the market reaching new lows is still on the increase, pointing to a further downside for the market. And perhaps most significantly, the small caps have already been breaking down. This happens as investors get nervous and flee to the presumed greater safety of the larger stocks. Companies buying back their stock are also a significant factor. Large companies are selling corporate bonds for 2% or less and using the money to reduce their shares outstanding. The *Economist* wrote that buybacks are four times the total of all

\*The yields given across the top of the charts are annual returns for one year or greater and percent change for three months and six months.



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institutional and retail stock purchasing. While that may be exaggerated, the dynamic is significant. Fewer shares outstanding pushes up the earnings per share with the smaller denominator (P/E) even if revenue and profits are down and the buying bids up price in the market. The enriched remaining shares is the same as if all shareholders were buying more shares. Like currency fluctuations, it changes the value without changing the number of shares held. Someone said it is like a snake eating its tail. It is an artificial stimulant that will accelerate the downside when the rate cannot continue. It is not a game for smaller companies needing their money for growth or limited in their ability to sell bonds.

The chart on the right gives the percent change year-to-date of the S&P 500 in blue and the Russell 2000 (stocks in size ranked between 1000 and 3000) in red. Year-to-date the Russell 2000 trails the S&P 500 by 11%. This kind of divergence which occurred in April and again in this quarter is highly unusual.

If we look at the Russell 2000 for the same period as our first chart of the S&P 500, the supporting trendline of the ascending triangle is already broken and we are waiting for the horizontal support line to also be violated. We have had the "double top" where the price went up to a previous high and reversed. This is a common sign of a bigger reversal in trend. The percent change for the last quarter is -6%, double the -3% of the last six months.



**How has the small cap divergence affected our returns?**

While I do not allocate or select by market cap, most of our positions tend to be smaller. They usually outperform because they have more room for growth, are less influenced by index buying, and do not have enough liquidity for the high frequency traders and other very large and sophisticated traders. The dominance of large cap stocks in determining an index such as our benchmark Russell 3000, as well as a look at current holdings is shown in the table.

Current Holdings by Market Cap				
Class	Rank	Mkt Cap as % Russell 3000	Positions Held	Percent Held
Largest 100	0-100	46%	6	12%
S&P 500	0-500	78%	11	22%
	500-1000	12%	3	6%
Russell 2000	1000-3000	10%	13	26%
Micro-Cap	3000-4000	1%	9	18%
ETF & Preferreds			14	28%

The 500 largest stocks by market cap control 78% of the Russell 3000 while we have only 22% of our positions in those stocks. While stocks in the Russell 2000 comprise only 10% of the influence on the Russell 3000, they comprise 26% of our holdings. And 18% of our holdings are from micro-cap stocks, which if there was a Russell 4000 would comprise only 1% of the capital. Alternatives would be to use an equal-weighted index as a benchmark, or if I'm buying five positions for you, to allocate the dollars invested in each purchase according to the size of the stock's market capitalization.

It is not hard to see why our performance has been influenced by the trends reviewed above for larger and smaller cap stocks. The Russell 2000 is in many ways a more relevant benchmark, and is shown in your reports this quarter.

### **Response**

A year ago I was also fearful, exited the market and was wrong. It cost me clients who were unhappy at missing the up market. This is not a business where even the best are right all the time, but may be wrong a third of the time or more, and still make up for it over time. However, many clients go to who had the best returns recently, often to be disappointed. Somewhat daunted by not being able to beat the market hands down the last couple years, and somewhat wanting to spend more time with my grandchildren, I have not been active in recruiting new clients and so the size of my clientele is less.

At any rate, instead of selling everything I have been gradually exiting the market by selling positions appearing vulnerable according to about a dozen criteria that I apply, resulting in having you 36% in cash. And I have you 5% or so short the market by using SH, the iShares short the S&P 500 (You make a dollar if the market drops a dollar). Gold and silver are relatively uncorrelated to the equities market and represent about 12% of our general allocation. The high income portfolio is another relatively uncorrelated portfolio and represents 18%. Of these, the preferred stocks are the least volatile. The REITS have been volatile, but as the price drops the dividend rises. With the euro and other parts of the world still problematic, foreign money is coming to the U.S. market (more than 17%) and the dollar is going up. That should support the REITs, except for retail which is overextended (double the square footage per capita as Germany) in an economy where money is not flowing to everyday consumers. There are a few other positions (.6%) I plan to hold for years regardless of the intervening markets. That leaves 27.5% is stocks; after the 5% short that comes to 22.5%.

So far, the defensiveness of this allocation is fortunate. Today is fairly typical of several recent trading days. The aggregate of what I manage was down \$19,889. Had the same amount been in the S&P 500 it would be down \$20,030. Had it been in the Russell 2000 it would be down \$65,490.

Given what I have outlined above, and given your own perceptions, let me know if you want to be more or less in what we normally consider stocks. Otherwise until I see signs of a reversal to the upside, I will continue to move individual positions to cash as they come up "Sell" on my individual criteria.

*Lee*