

December 31, 2015



Clients,

It has been an exciting and high energy quarter for me, fueled in part by attending the national AAIL investment conference in Las Vegas, watching the concurrent presentations I missed, and preparing for and then presenting to 90 investors of our Twin Cities AAIL chapter. Even if I don't swallow most of what was presented at the conference, or it is of little value, the process of sifting and sorting is valuable. Sometimes the footnotes lead to articles which are significant, or stimulate research I do to confirm or refine ideas and the data presented.

One of the best presentations was by Patrick O'Shaughnessy. My approach of using statistical tools to discover and then implement screens came primarily from his father. Regardless of your age, I highly recommend Patrick's book, Millennial Money: How Young Investors Can Build a Fortune. While I might challenge some of the details, it provides a good background for how I understand markets and go about investing much of your money.

The biggest issue at the conference was whether to buy ETFs based on passive indexes, or go with active investing, selecting stocks in order to do better than average. It is not as much an either or as usually portrayed. For example, passive investing is moving towards "smart beta" meaning indexes designed to take advantage of factors such as size, momentum, or value having statistical probabilities of excess returns. Basically an extension of that is what I do in my statistical strategy with a wide variety of variables, so maybe I'm a passive investor?

Few of the indexes are truly passive. The stocks in the S&P 500 are selected by a committee, mostly based on size but not entirely. The same for our usual benchmark, the Russell 3000. The results relate to dollars in the market, not to an average of stocks. For example, the cap-weighted indexes have traded in a fairly narrow range for most of the last year. The S&P 500 in the last year went from 2,059 to 2,049 or a change of .5% – less than a typical daily trading range. Unlike the indexes, I don't vary how many shares I buy based on the market cap of the stock; I generally equal-weight buying about the same dollar value for each stock in your account. The equal-weighted S&P (SPEW-X) is down 4.3%, not a lot but almost nine times as much as the S&P cap-weighted index. In a sense cap-weighted indexes are not passive; they are tilted towards large cap stocks and momentum stocks, which will come and go in favor.

Value stocks (IVE) are down -5.6% over the past year. Growth stocks (IVW) are up 3.8% for a spread of 9.4%.

Posted under Papers on my website is a very significant article by Jason Hsu titled "If Factor Returns Are Predictable, Why Is There an Investor Return Gap?" Under the article are related reports of studies I have done. The pattern is that different stock characteristics such as small or large, value or growth, volatile or stable, momentum, high quality fundamentals or low, domestic or international oscillate up and down in their relative advantage. Robert Schiller was cited in a footnote that the cycle is 5.5 years, but I don't find it that precise. After a couple years or more of substandard performance, investors leave their mutual fund or money manager and move to one with the better recent returns. These promptly head south. My clients who have left had returns half of my overall returns, mostly because they leave at the wrong time. Investors with a given mutual fund have returns half or less of the overall return of their fund. The mutual fund manager is not to blame since when investors pull out their

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money, the fund manager has no choice but to redeem shares regardless of price. So the price drops and more sell. The Hsu article focuses on how individual investors can take advantage of this dynamic by monitoring fund flows and profiting from reversion to the mean dynamics.

In the past I kept searching for screen criteria that would consistently do better than the market. This rather scientific and academic approach of looking for eternal truth is misguided relative to the extremely sensitive equilibrium of market systems. Instead of looking at static variables, such as price to earnings or price to sales, I need to look at dynamic variables such as changes in price, earnings, sales ratios or growth to value.

As to style oscillations such as growth beating value by 9.4% over the past year, should I be developing screens based on what worked a year ago, or two years ago, or five years ago? (I intend to run some tests to find out.) Should we not even look at returns for the last year, or look at them with a view to buying what is out of favor? What is clear is that choosing styles or investments according to the momentum of the last year leads to inferior returns. Momentum works, until it doesn't. The forces of equilibrium are stronger bringing prices back than for prices to run away from the pack. Indexed buying and selling accentuates the equilibrium. Even so the problem with trying to buy what is out of favor is that things can stay out of favor longer than you or I can stay solvent or patient. The problem with buy and hold through thick and thin is that most of us can't stick to it when things are down for a year or two or three.

In this context, I am very excited by the findings of what is reported in the accompanying report "Playing Defense." If you are not familiar with the methodology I would suggest reading it a second time and calling if you want to talk about it. I have never seen findings from anyone having this degree of statistical certainty for returns one year out. The portfolio has been initiated in four accounts that had enough cash to buy a representative ten positions. For other accounts, I could start buying positions monthly until we get a respectable sample, or sell something else in order to buy.

As for our future, I think it is highly unlikely that our portfolios will be down a year from now, to say nothing of down ten or fifteen percent, or over a longer time period such as two or five years. I base this on the following opinions and data:

- We have a most recent screen count of thirty in the research described in "Playing Defense."
- While markets are fairly valued according to earnings, currency supplies from the world's major central banks will support asset prices.
- Low unemployment points to a thriving economy, although usually to fairly flat overall markets.
- Gold, small cap and value are already down. Reversion to the mean should mean appreciation even in an overall flat market. Hedge funds are buying gold, small cap and value.
- International stocks are down, but so are their economies. We're generally not there. As to when we should be, I'm not sure. The same is true for energy. (Most of what is shown in the WA Performance report is in my personal account.)
- Historically it is very rare for the stock market to drop and not rebound. What matters is not how low it goes but where it is down the road when one needs to sell.

Therefore, I think we should be close to fully invested. If markets would drop ten or fifteen percent, I would see it more as a time to invest than a time to exit for fear of further declines or a prolonged lower valuation.

Thanks for trusting me with your funds. This quarter saw new clients and no departures, so we are in a growth mode.

*Lee*