

July 11, 2009



Clients,

For the last two months the equity market as represented by the Russell 3000 has been trading in a horizontal range between 500 and 550. While it could break out in either direction, it could also stay that way awhile. Within a horizontal market, the best options are to find opportunities outside the U.S. equity market, such as Asia and Brazil or in currency-related ETFs, or to find exceptions within the market trend. For now, I'm mostly watching.

This quarterly letter will be an update on the three strategies I use in selecting positions:

1. A strong rationale,
2. Statistics and data mining, and
3. Tested sources.

Game Over by Stephen Leeb is an excellent summary of the energy and natural resource challenges facing our planet, with consequent dramatic economic impacts. While other books and newsletters present similar data and perspectives, Leeb's book is the best synthesis I have found. I thought it sends an alarm without being alarmist. Reading it not only helps understand major economic and investment changes and challenges, but will affect your decisions as a consumer and citizen. It will also help you to understand where I'm coming from in many of the investment decisions I make in your account(s).

Until recently, the sole data source for my data mining methodology has been monthly data from Stock Investor Pro published by the American Association of Individual Investors (AAII). With the more erratic markets, I have begun building a database of weekly data. I have also begun using a program called XLQ which enables me to access a broad range of technical indicators and import the data into my data mining tool, KnowledgeSEEKER. Other charting and technical tools such as TeleChart and StockFinder enable screening by technical indicators, and even backtesting, but do not facilitate the discovery of optimum screens except by testing one hunch at a time. With Office 2007 I am no longer limited to importing only 65,000 records into KnowledgeSEEKER. And, with an upgraded version of KnowledgeSEEKER I have found a way to export say a thousand nodes or screening sets and sift and sort through them much faster than I could before. I partition the data into learning and testing sets, and can then immediately see how a particular screen performs on the second or test set. I tested some sixty screens that I have selected over the last fifteen years or so by running them all on the last one hundred months of data and compared how they perform on current data. An example of some of this research, and related findings, is reported briefly on the attached document "Stock Screen Rotation".

I know that all of this may be more detailed than most of you care about, but the point is that I'm excited about the new capabilities. I'm optimistic that we can do very well capitalizing on more current patterns. I also think such research is a better use of my time than reading many commentators trying to find something to write about and speculating on possible short-term market trends.

This leads us to the third strategy and my use of tested sources. For actual implementation, I make the most use of the Nicholas Vardy newsletters. I had him speak to our local AAII chapter May 26 on his way back from Las Vegas to London, and had the opportunity to take him to dinner. While his newsletters are mostly discretionary, he presented a way to emulate the Harvard Endowment approach which is a more systematic and passive form of investment. We may add that approach.

An alternative to mutual funds.

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We have been implementing the High Dividend portfolio since 2002 with remarkable and consistent success. During that time, the price of positions has doubled while the Russell 3000 is at 90% of what it was then. Year-to-date, we are up 12.8% while the same money in the index would be up .3%. I primarily select stocks with consistent and significant appreciation from the five percent or so of stocks with the highest dividends. I also review and select from a variety of newsletters such as “Forbes/Lehmann Income Securities Investor” by Richard Lehmann and “High-Yield Investing” by Carla Pasternak.

At this point there are several newsletters that I like but only implement an occasional suggestion. These include the “China Stock Digest” by Jim Trippon, “Real Wealth Report” by Larry Edelson, “The Complete Investor” by Stephen Leeb and “Outstanding Investments” by Byron King. For timing and market directions I rely mostly on “Sentimentrader” by Jason Goepfert and “The StockCharts.com Market Message” from John Murphy and Arthur Hill. For broader economic perspectives I always read the Economist, “Economic and Market Perspective” by Jim Paulsen (Wells Fargo), and to a lesser extent the Wall Street Journal.

I no longer mail the Performance Summary for my book of business. I do post it on the website eight times a year. The year-to-date annual rate is 23% while the comparison Russell 3000 is at 6%. The seventy-five uranium mining positions had the best quarterly returns at an annual rate of 1090%, but it is a portfolio that goes both ways. I encourage you to reference the Performance Summary on the website if you want to compare your individual performance on a specific portfolio or overall performance with the aggregate for all accounts. You may find a portfolio that you would like to shift funds to or from. And, of course, you can share the Performance Summary with your friends and relatives.

My client base has changed very little over the past year. Now that markets have returned to some sanity, I’m feeling more comfortable in selectively taking in new clients. As the years progress I see myself as becoming more selective and also limiting the workload by writing shorter reports and moving to longer-term investing with less daily monitoring, buying and selling.

Lee