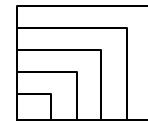


October 10, 2009



Wenzel  
Analytics  
Inc

## Third Quarter Client Letter

### All aboard!?

The most obvious news for equity investing is that since the low of March 10 through the end of the third quarter, the market as measured by the Russell 3000 has **risen 59%** or at an **annual rate of 129%**.

Sadly, most Americans have missed most of this ride up. First, most are more dependent upon jobs rather than money for making their money. Even baby-boomers who should be prepared for retirement are ill prepared, somehow thinking that Social Security plus \$100,000 will support them. At 4% withdrawals, that won't go far.

Second, for American investors, they or their mutual fund managers were sitting extensively in cash. The trading volume on this run-up has been modest. The amount of cash is almost double previous historical records. True, some of that cash is related to the bank crises and commercial and industrial decisions. Still, most individual and professional investors have been nervous and heavily in cash, missing most of the action. Of course the nervousness is what fuels the market. If no one was nervous, everyone would be in the market and there would be no one left to bid it up.

Third, the high returns are from companies with the lowest sales growth, lowest earnings and lowest cash flow. Many fundamentalist investors assume that making money in the stock market is a matter of picking quality companies, and thus they missed most of the market gains. My interpretation is that when the market was dropping there was a flight to quality. As the market recovery started, the poorest quality companies were the most undervalued and the most often sold short. Thus they enjoyed the greatest price appreciation.

### Is it smart to stand aside?

Is this a case where wisdom is not always measured by the short-term results? After all, since risk is measured by standard deviation or any change in price, risk has been very high. Were the investors largely on the sidelines or in

quality stocks making the "right" decision, even if so far events reveal a lot of missed opportunity? Or are such rationalizations merely sour grapes?

A year ago I stayed far too long with stocks related to energy, mining and commodities assuming that since they related to real stuff that would soon be in short supply, it was a good investment for weathering the storm. In hindsight I wish I would have exited more and sooner. As I read a wide diversity of opinions on investing, and as I introspectively look at how I make sense of things, I am increasingly aware that one can develop a good argument for both sides of most investment decisions. Instead of the logic or persuasion, I am increasingly going with the data about where the market strength is now and then going with that trend. When the market reverses, I plan to exit sooner. The exit is always down from the high, and thus a perceived loss from perceived maximum gain. But to predict a reversal is a much more precarious business and hard to time. The maxim is "Don't fight the tape."

### Our Comparisons

Our investments have been somewhat defensive with higher amounts in cash than usual, yet I mostly expect to do better than the equity benchmark. Wenzel Analytics investments for the same period of March 10 through September 30 have **risen 55%** or at an **annual rate of 119%**, thus trailing the Russell 3000 benchmark only slightly. To compare cash plus investments or the total value of your accounts, the rise has been **44%** or an **annual rate of 91%**. Obviously, it was a good time to be as fully invested as possible. Ah, the beauties of hindsight.

The first thing I would note about these comparisons is that few general investors even know their performance against benchmarks. It amazes me how casual people are about matters of such significance for their financial wellbeing. This book Nudge by Richard H. Thaler and Cass R. Sunstein has been a fascinating read about how people operate on default and procrastination.

*An alternative to mutual funds.*

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The second observation about the comparison between our performance and the Russell 3000 is that it raises questions about what is an appropriate comparison, or if the comparison is even relevant. Would it not be a more apples to apples comparison (our apple tree is loaded with apples) to leave the cash out of the comparison between the Russell 3000 and our performance? Yet, the allocation between cash and investments is an important part of what you pay me to do, and an important variable in our results. Should we search for another benchmark that incorporates cash or other asset allocation variables? With increasing international investing, should I find a more international benchmark? And of course when it comes time to buy something with the fruits of your investing, the comparisons don't matter. It is only absolute returns that matter, which is why our charts also show those as well.

The other comparison is between your results and my overall results. I always feel bad about it when it happens, but sad to say half of you have performance below my average. While some of that is due to being more aggressive or conservative in selection and selling decisions, I think most of the variation is due to accidents of when cash was available and what positions happened to be on my buy list at the time. The size of the account affects the number of positions, and thus the predictability of results and the balance between stocks and ETFs.

### **Ongoing Allocation**

I originally thought that you as my clients would select strategies and portfolios, and I would then implement those decisions by buying stocks in the respective portfolios. Some of you have given tentative initial direction, but it is rare that anyone asks for a change in allocation between strategies and portfolios. While you are welcome to compare my overall report to your individual report and request a reallocation, I have come to appreciate your entrusting me with strategy and portfolio balance and selection. It is a practical way to operate.

My process is to go through and sell individual positions that I think have either maximized their gains or are in danger of detracting from overall performance. Then I review the cash in each of your accounts, update my buy list for each portfolio, and go through and select what I consider promising stocks to create a good balance for each of your accounts when

considering many factors such as what I know about you and your situation plus factors such as strategy, portfolio, sector, country and volatility.

While I carefully balance the allocation within your accounts, I want to remind each of you to regularly make sure that what I am doing with your investments balances against your other investments that I do not manage. If I manage only a portion of your investable assets, I assume that you are balancing what I do with the remainder of your allocation. I would be glad to offer perspective and suggestions on the allocation of assets I don't manage, and to review how either the assets I manage or the assets I don't manage might be adjusted to maintain an appropriate balance.

### **Currently**

As for the current market, my perspective is that until the Federal Reserve changes their policy, it is a time to "make hay while the sun shines" but be ready to take cover, not from every cloud that goes over but when the storms hit. I think the prognosis for the markets, especially emerging markets, is better than for the domestic economy.

I have found some new research tools that allow me to process more research data more quickly, and of course that is exciting for someone as analytical as I. My client base has hardly changed over the past year. Now as things look more promising, and perhaps as I have regained some of my composure, I have several new clients coming aboard.

In view of the current dialogue regarding the financing of medical services, I have pulled together some perspectives from fifteen years ago when I was working and studying in that area. I encourage you to take a look under Papers on my website, and offer your reactions.

Thanks for your trust and your business.

Lee