

April 6, 2010



Clients,

Accounting for Performance

While our returns were good last quarter, they weren't as good as the U.S. market measured by the Russell 3000 or the S&P 500.

I wrote almost all of your reports thinking that my management fees were not calculated in the returns, and then found out that due to a change within the software, the returns have been net of management fees for a year or two. The management fees are attributed to the cash accounts, so your overall performance numbers are affected but not the individual strategy and portfolio numbers. So we have been doing better than I thought. After or including fees, the overall returns last quarter were at an annual rate (Time Weighted Return, TWR) of 14% compared to 24% for the Russell 3000. The corrections will take a while and have to wait until next quarter's reports.

The primary reason our returns didn't match the U.S. market is that we are heavily diversified outside the U.S. market to protect against currency variations. While the Dollar has been in a general downtrend since October 2008, it went up this past quarter due to the anxiety over Greece and the Euro. One of Arthur Hill's

charts from StockCharts.com is to the right. Increasingly I am finding that by watching fluctuations in the dollar, I can predict the movement of many stocks and ETFs. While we are riding the downtrend of the Euro (EUO), a short-term play as recommended by Nicholas Vardy in the Megatrends portfolio, in the longer perspective I think the Dollar will continue to decline.

I have sold a number of the oil services and energy related stocks in that we were over-weighted in that direction. Energy and commodities will come back, but the excess of natural gas derived from the newer horizontal drilling

technologies and the fracturing of the shale deposits is changing the energy markets. The most direct play we have in that is in Westport Innovations (WPRT), a Canadian manufacturer of natural gas engines for trucks and commercial vehicles. Because the Loonie will likely continue to appreciate against the Dollar, we will be buying Canadian high-dividend investments as well.

To what degree are we outside the Dollar? The exact amount is hard to determine because so many companies are spread around the world, and while Deere and Caterpillar, for example, may be domestic corporations, their operations are worldwide and their profitability is heavily dependent upon currency fluctuations. In addition to the strategy/portfolio allocation based on my selection methodology, I regularly do analyses by other dimensions.



An alternative to mutual funds.

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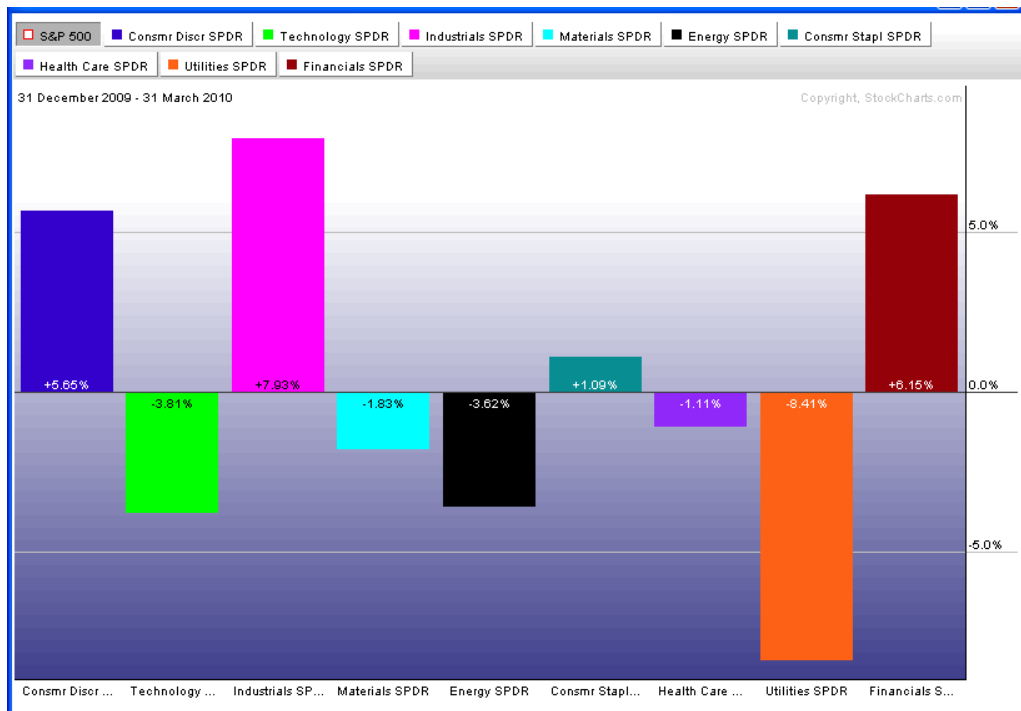
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The table on the right shows a sector analysis of holdings at the end of the quarter. Gold is primarily a protection against currency depreciation (5.6%). International or country ETFs comprise 17.4%. Most of the Basic Materials (17.1%) and Energy (12.4%) companies are either based outside the U.S. or have most of their operations outside the U.S. Just adding these together, we are over half.

Sector	Total
Cash	8.0%
01 - Basic Materials	17.1%
02 - Capital Goods	3.3%
03 - Conglomerates	1.1%
04 - Consumer Cyclical	1.8%
05 - Consumer Non-Cyclical	1.9%
06 - Energy	12.4%
07 - Financial	0.8%
08 - Health Care	1.3%
09 - Services	3.1%
10 - Technology	5.6%
11 - Transportation	3.1%
12 - Utilities	3.7%
Gold	5.6%
ETF or CEF - Income	11.0%
Intl ETF	17.4%
Unidentified	2.7%
	100.0%

In addition to the management fees confusion and the currency variation, our performance last quarter is also explained by putting the sector weighting shown on the right against the performance by sector as shown in the bar chart below. Our Cyclical portfolio did very well in most of your accounts, which would fall primarily in the rose-pink Industrials on the chart. Fortunately, we had relatively little in the orange Utilities. But our three largest sectors, Basic Materials, Energy and Technology, were the next three lowest performing sectors relative to the S&P 500. Of course much of that is attributable to the Dollar.

Is that reason to move out of these sectors? I don't think so. So far in April, the same chart shows energy up twice as much as any other sector, followed by Basic Materials and Technology while Consumer Discretionary (the dark blue on the left) continues to be strong.



Account Variations

The table on the next page is an analysis of the variation in returns by your client account. If you chose, you could compare your performance to the minimum, maximum and average of all the accounts that hold the same portfolio. The variation comes from how and when I fill each portfolio for each of you. When I see that there is cash to be invested, I analyze each of your portfolios and pick from my current buy list to add portfolios or add positions to your current portfolios. Each of your holdings is unique not only in the portfolios you hold, but in the positions within each portfolio dependent upon what was on my buy list when I was adding to your portfolio. As I have been shopping for advisor brokers, I find that this approach is much more tailored than what most brokers are set up to support very efficiently. The typical pattern is to have maybe three

allocations such as aggressive, moderate and conservative, with all accounts within each allocation style then having the same positions in the same proportions. If you have multiple accounts, that means each account has the same positions. If you happen to have say a larger traditional IRA and a small Roth, that means that the Roth has all these very small positions (and more transaction costs).

To explain the table a bit more, the numbers under ROI Last Quarter are an analysis by client account. The columns on the right give a total Return on Investment (ROI) or Time Weighted Return (TWR), if the dollars were all consolidated and not by account.

Comparing the Average of accounts, All-ROI and All-TWR one can see that one sometimes gets quite different results depending upon how one does the calculations. So as is often the case, it is best to look for large patterns rather than draw precise conclusions from the presumed accuracy of a single number.

Account Variations Table

Investment Symbol	ROI Last Quarter					All-ROI	All-TWR
	Count	Minimum	Maximum	Std Dev	Average		
Rationale	32	-14	44	12	6	10	12
Gold	34	-21	6	8	-6	-7	-3
International	37	-27	25	11	2	2	1
Momentum	18	-68	27	31	-15	-7	2
Resource Scarcity	37	-38	352	105	56	21	31
Singles	5	-12	137	63	26	80	79
Uranium	10	8	175	53	61	56	56
Statistical	31	-14	72	21	22	23	26
Consistent SIS	22	-52	28	24	-15	-14	-6
NF33	12	-23	33	15	17	17	17
NF40	22	-18	24	11	9	4	6
RdpsvolCCIsd3y	11	26	72	13	48	59	67
Resilient	14	-24	32	22	8	23	10
Shadow F	20	11	215	63	95	80	60
Weekly16c	11	-3	13	5	2	5	8
Tested Source	33	-4	52	12	13	15	12
Cyclicals	6	10	196	73	47	28	10
Income	27	-14	15	8	2	7	6
Megatrends	33	-8	54	17	26	28	28

In interpreting the returns for different portfolios, it is good to remember that one can often be right about the long-term trends, but wrong in the precise timing for when things will unfold.

Plans Going Forward

So what are my plans going forward?

Statistical

Since the Statistical strategy performed the best and has usually outperformed over time, I plan to move into more newer and more statistical portfolios.

The newest portfolios have performed the best; the older portfolios haven't done as well. The **RdpsvolCCIsd3y** (Rank dividends per share, volume, Commodity Channel Index, and standard deviation over three years – aren't you glad there is an acronym?) is derived from data mining I did last summer. It has 6.9% of overall allocation. The **ShadowF** is from research in 2005 using data mining to refine the AAll Shadow Stock screen. I did follow-up research on the intervening performance of dormant screens, and decided to re-implement the screen, with a current overall allocation of 8.7%.

The **Consistent SIS** (Sector, Industry, Stock) has not done well and will be discontinued. At least in this trial, the premise hasn't worked of picking stocks with high relative strength that were in industries and sectors of high relative strength. The sectors and industries were to buoy up the individual stocks. Actually, the empirical support was weak and the portfolio probably should have been in the Strong Rationale.

The **NF33** and **NF40** (Non-Financial) screens of a couple years ago have positions more than a year old which I have held primarily because they happened to be in energy and commodities.

Tested Source

The variation between the different metrics on **Cyclicals** comes from buying activity at different times as I have been moving back into the portfolio due to our place in the economic cycle. It is performing well and we are up to a 6% allocation.

I have been doing considerable research on **High Income** investments and adding to many of your portfolios until we are now at a 13.5% allocation. I have found inconsistency between data sources in reporting yields, due to most reporting capital distributions from closed end funds as part of the yield. The portfolio charts always lag on recent performance as prices drop at ex-dividend date when qualifying for the dividend and the actual dividends are not received until a few weeks later. The shipping companies were sold this past quarter after dropping their dividends. I look for stability from this portfolio, with good price appreciation on top of average 9% dividends. I'm making increasing use of Karla Pasternak's high-dividend newsletters, both domestic and international.

The **Megatrends** portfolio with 14.2% of total allocation exceeded the Russell 3000 in returns and will be continued. Vardy's are the only newsletters where I am implementing most of the recommendations with a dedicated portfolio.

Most of you were in O'Neill **CANSLIM** portfolio for about six weeks during the quarter. The American Association of Individual Investors (AAII) publishes performance results of sixty or so screens from exceptional investors. The CANSLIM screen from William O'Neill has outperformed all others. I have stayed away from it for years because it is volatile, usually selects very few positions, and sometimes will not select any positions. On January 26 I implemented the screen which had two positions, Buffalo Wild Wings (BWLD) and VSE Corporation (VSEC). Both dropped significantly at different times, and were sold after about six weeks when things had somewhat recovered for a six percent loss. I plan to go back to it in a modest way when it again finds qualifying stocks.

Rationale

International (mostly country funds) with 7.8% of total allocation was down this quarter due to the exchange rates.

I did what I thought was a very interesting study this quarter on the correlation between economic variables and stock market returns. I read [From Poverty to Prosperity](#) by Kling and Schultz who lean to the Austrian Economics School and highlight the importance of cultural and institutional settings as preconditions for economic growth and prosperity. They talk about things like solid property rights, clear and realistic regulations, willingness to allow disruptive technologies and innovativeness which relates to age and demographic variables. These overshadow natural resources and capital. So I went to [Pocket World in Figures](#) published by The Economist magazine and looked up rankings on sixteen of my favorite countries on variables such as global competitiveness, business environment, business innovation, technological readiness and expenditures on R&D as a percent of GDP. I then averaged these ranks and compared them to the combined rank of growth in stock prices over the last month and last year. The correlation was a minus .20, which I don't think is particularly significant.

While there are many ways to challenge my little study, I think the presumption that the stock market is a reflection of the economy is largely myth, even if one posits that the market is a leading indicator by six months. The market is a balance of supply and demand as out of a mixture of fear and greed investors have to decide what they are going to do with their money. How the people with money make money is quite different than whether people without a job can find a job. I still believe that emerging market economies will out-perform going forward, but haven't found a recipe for which countries in which quarters. The best I have to go on are to balance optimistic economic factors with past strong and consistent price performance (technical analysis). Based on that, my little study points to Australia and Canada followed by Singapore.

The **Momentum** portfolio with a 1.1% allocation will disappear as soon as seems optimal given some bounce back up of down positions. **Resource Scarcity** with an 8.4% allocation will continue to be a significant holding, although less so. The relatively low allocation (2.2%) to the Uranium portfolio is a long-term holding. The **Singles** (.7% allocation) are a few well-liked positions that don't fit elsewhere. They are volatile, and while nice this quarter are too often in the wrong direction.

Gold was a significant deterrent to our performance this past quarter, although the true believers see it as merely a buying opportunity. Most of the gold mining companies have been sold. I see gold as defensive or insurance rather than as a moonshot for making huge returns. My plan is to continue holding 5-8% in most accounts, and if you are willing, to add **covered calls**. I have done this in my personal account and it is working quite well.

So let me give you a refresher on covered calls. A covered call is when you hold a position, you agree to sell at a maximum or strike price, no matter how high the price goes after that. One collects a premium in return for selling the option. In this case, gold is now selling for about \$1,100 an ounce or \$110 a share of GLD which most of you hold. Assume that if GLD went up to \$165 we would sell it and pocket the gains for fear that it would cycle back down. If we sold an option for \$165 good until December, we would collect \$10.40 in premiums for each share (\$1.04 per contract, current auction), which adds 10% or so to our return over eight months, maybe 15% annualized. If the price never goes to \$165, we keep the premium. If it goes to \$165 or higher, the option is called meaning that we sell it for \$165, which was our plan anyway, and still keep the premium. We can do this at Scottrade in both IRA and non-IRA accounts. (We cannot sell puts, meaning we could collect a premium in return for buying the stock should it go below a threshold, say \$75 for GLD.) If by October it appears highly unlikely that the price will go to \$165, we could buy back the option we sold for very little, and repeat the process. Since options are outside what we have discussed before, **E-mail me or call if covered calls on GLD is something you want done in your account.**

Scottrade Issues

In this letter last quarter I went on about all my issues with the new Scottrade interface. Well, I have cooled my jets some. After scouting the field, I have not found a better alternative.

I learned that the Scottrade Advisory unit is recruiting for a new chief executive. Presumably when the position is filled I will see some improvement in the interface. I went through step-by-step and click by click and documented the problems, what could be done to improve matters, and the time required. My rep who has been great to work with forwarded it on to the appropriate development team. If I'm buying more than one or two positions in each account, it is faster to access the account the same way you do. I would appreciate the account ID and password from many of you. (I will make a note at the end of you individual reports.)

Most of the alternative brokers are more expensive. I moved my personal accounts to Interactive Brokers (IB) to test the waters. Trading is fast and efficient. Trades range from \$1 to \$12 or more and usually less than \$3. It depends upon the exchange and the number of lots within the trade. Support staff are hard to reach and sometimes not very knowledgeable. Retrieving data into my

portfolio management software has been problematic; extra steps are required and the name of the position doesn't come in, only the symbol.

I have thought about implementing as a Tested Source portfolio James Cordier's portfolios selling commodity options. Some of you heard Mr. Cordier and Michael Gross present to our AAll chapter on January 29. While they now require a minimum \$100k portfolio and have significant transaction fees, I think I could sell the far-out-of-the-money and distant commodity options based on e-mailed statements I receive. Doing so would require an Interactive Brokers account. (IB also facilitates buying on 68 exchanges around the world, making it easier to buy individual stocks in other countries.) The information on commodity options is at LibertyTrading.com, and in their book [The Complete Guide to Option Selling](#): How selling options can lead to stellar returns in bull and bear markets. I opened a SEP account with them three years ago, and a Roth account a year ago. While there was a significant drop in 2008, the first account is above the initial level by 10% and the account opened eleven months ago is up 65%. **Let me know if you have an interest in commodity options.**

I didn't intend to go on so long. I think the writing and having to spell things out is probably more important for me than for how many of you actually read this far. Thanks for your trust.

Sincerely,

Lee