July 7, 2010

Wenzel Analytics Inc

Clients,

The Market

I didn't expect the market to drop as much as it did the last couple weeks of June. I expected the S&P 500 might drop to 1065, maybe 1040. Today is the first strong recovery day, with the market at about 1050 we are well above the 1040 support line. It is always hard to know when to sell as things go down and when to wait it out.

"The only thing to fear is fear itself." In the market we have a self-fulfilling prophecy, and a contamination between political, economic and investment perspectives. There are people who control a lot of investment money and have a prima fascia dislike for Obama and his administration. There are a lot of those – enough to shape the market. These people have been holding back on investing in the market for fear of run-away debts and economic collapse. In contrast, I tend to agree with the Keynesian perspective and Depression-era experience that stimulus spending is necessary to revive an economy. I can understand the German reticence in view of their runaway inflation of the Thirties, but think that sometimes what we learn from one experience is not necessarily appropriate for future environs. (It is called neurotic or the basis for an addiction.)

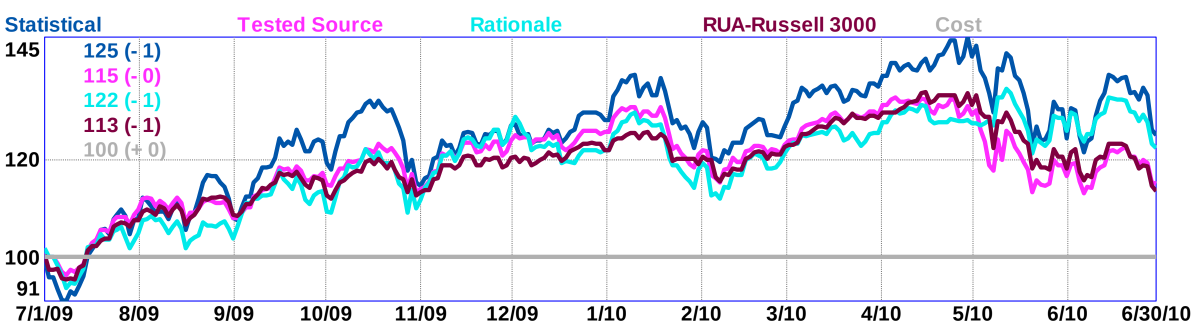
A drop below the lows of this past week will be time to start exiting positions, even if painful. We can get back in later.

Book-of-Business Returns

The book-of-business performance report by strategy and portfolio is at [www.WenzelAnalytics.com.](http://www.WenzelAnalytics.com) I never know whether or not to include the general report in my quarterly mailings. Look at it online if you want to compare your performance to my average, or compare on individual portfolios. I know the financial news and recent markets have many of you anxious. Let me know if you would like a less volatile approach or find specific portfolios that meet your needs better than how I have things allocated.

Since I didn't include the overall-all performance report, I will repeat a couple highlights here.

Strategy Comparison, Last Year



Reading from the upper left corner, the Statistical strategy has gone up 25%, the strong Rationale 22%, the Tested Source 15% and the Russell 3000 13% over the past year.

An alternative to mutual funds.

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The table gives the allocation for all managed accounts as well as the Internal Rate of Return and the Time-Weighted Return for each strategy and portfolio. (The website report describes the difference between the two types of returns.)

Wenzel Analytics Allocation and Returns by Allocation

Strategy	**Portfolio**	**Allocation** End of Qtr	**Internal Rate of Return** Annual rates of return		**Time-Weighted Return** Annual rates of return	
			Quarter	12 Months	Quarter	12 Months
Cash	Cash	10.4%				
Rationale	Gold	6.8%	38%	43%	51%	40%
	Intl	7.3%	-46%	12%	-40%	23%
	Momentum	1.3%	-45%	25%	-48%	8%
	Original	2.5%	-20%	6%	-27%	21%
	Resource Scarcity	9.0%	-40%	22%	-45%	15%
	Singles	4.5%	-64%	-32%	-49%	-8%
	Timing	2.4%	838%	814%	N/A	N/A
	Uranium	2.0%	-38%	1%	-30%	4%
		35.7%	**-19%**	**24%**	**-10%**	**22%**
Statistical	Consistent SIS	0.7%	-6%	N/A	3%	N/A
	DnLaNYSE	0.8%	New			
	Non-Financial	2.6%	-76%	17%	-76%	-9%
	RdpsvolCCIsd3y	2.5%	-26%	9%	-38%	N/A
	Shadow F	5.2%	44%	N/A	76%	N/A
	Weekly16c	4.8%	-44%	25%	-50%	N/A
		16.7%	**-29%**	**20%**	**-27%**	**26%**
Tested Source	Cyclicals	6.3%	-56%	-2%	-52%	43%
	Harvard	0.4%	-28%		-29%	
	Income	14.5%	-23%	17%	-17%	22%
	Megatrends	13.1%	-46%	5%	-43%	11%
	Special Sit	2.3%	New			
	Sullivan	0.5%	New			
		37.2%	**-40%**	**6%**	**-37%**	**15%**
Total		100.0%	**-30%**	**17%**	**-24%**	**20%**

You might have observed that the allocation to the best-performing Statistical Strategy is low. Some of that is because I have been waiting until my research turns up with new screens, or validations of old screens. Another reason is the best performing Statistical screens tend to be volatile, which means I sell them more frequently and if the market doesn't look solid delay I delay in buying again.

Research this past quarter

I spent much of the quarter doing research while watching the markets out of the corner of my eye on my notebook computer. Patterns are harder to find. I think that when the fear ratchets up, the normal fundamental drivers disappear. I presented my research and methodology to the AAII Special Interest Group. While most of the data tables wouldn't mean much without the verbal presentation, I have posted a handout describing details of the methodology on my website under Papers.

The best pattern I found is in stocks that have declined significantly over the past three years, are now rebounding, have mid-range total assets to total liabilities, and are on the New York Stock Exchange. The reversal patterns consistently outperform the plain momentum or new highs.   Stocks that have gone down but still have evidence of good financial management and the credibility that comes with the NYSE have been doing the best.

In all my research, what is happening in the overall market tends to overshadow everything else. While some researchers find stock characteristics that outperform over long periods of time, such as twenty years, the outperformance is not very consistent over different months and hardly enough of an edge to merit implementation. What gives a 1% increase in returns over a thousand stocks may not do anything for the ten stocks I pick. I'm becoming more aware that there is nothing about a stock, the company behind it, or a price pattern that in itself predicts outperformance. A company with good fundamentals may not give better returns than a company with poor or mediocre fundamentals. Stocks go up for only one reason: demand exceeds supply. Stocks go down when supply exceeds the demand. All other factors impact a market to the extent that they impact the demand for a stock. *Nothing is worth anything if nobody wants it*. That applies to not only stocks, but gold, real estate and anything else one might want to sell. Even money has no inherent value. It is all based upon current demand. And demand is strongly influenced by emotions and fades.

Except for sitting double-short and the collapse on May 6 coming along, our best performer has been the Shadow portfolio. (See Table above.) This was originally an AAII screen that I have adapted by using data mining outcomes. Based on this experience, I have decided to try and play in the backwaters where the big fish can't go. Much of the market is driven by quantitatively derived algorithms that trade huge volumes intra-day or over very short time periods. For the small players, money is to be made trading stocks with liquidity too low for the large institutional machine traders.

I have focused my research on results one quarter out. Using one-year results means that one doesn't have any data on patterns less than a year old. Going to monthly or weekly results gets into a lot of noise and starts to compete with the very sophisticated trading algorithms of short-term traders.

I took some of this from a presentation by Janet Brown at the Money Show in Las Vegas. A client once kept encouraging me to follow her approach and her newsletter *No Load Fund X*. In *Hulbert's Financial Digest* her fund is number one for risk-adjusted returns over 25 years. Her approach is to buy whatever is working now and forget about all the theories and reasons.

Low beta stocks are stocks that do not correlate with the market. In an up-market, one needs to ride the strength of the market. In a down or ambivalent market, one needs to escape the influence of the overall market, even if returns are less. So I have been assembling a new database that includes beta, as well as sector and industry beta. I have also added a number of price-to ratios, such as different kinds of PE ratios as well as price-to-book, price-to-sales, and changes in these ratios for each stock, since I am finding the ratios predictive. Technical patterns, such as price change over different periods of time, are always predictive but assume that a future market trend is going to be like the past.

Personal

Our daughter Kara had a stroke in mid-April that affected her speech and cognition. Jan spent a few weeks with her in Belleville, WI, and I have made a couple trips. Kara got her driver's license back this past week, which is a big deal when you live twenty miles out of Madison and work. She has been working part-time.

As if the market hasn't been adventure enough, I have taken a couple adventures this past quarter. I rode my bicycle to Belleville for the Memorial Day weekend. On Thursday I rode to

Winona (130 miles), got there about supper time and was able to get a room at the Sterling Motel (my middle name). Friday I rode limestone trails to Reedsburg (118 miles) and I got to Belleville a little after lunch in Mt. Horeb on Saturday (70 miles). By the third day I was taking note of the hills. There is a reason they named the town Mt. Horeb (a 450' climb).

This sounds like one of those Christmas letters that we all moan about, but I go on…

Then on Scott's birthday, June 18, I began a paddle-portage-bike trip from off the Gunflint Trail to the Grand Portage where the Voyageurs transported pelts and supplies and down to the town of Grand Portage. I saw lots of moose, otter and birds. I had been carrying my pack and canoe on a single trip across each portage for the 4.5 miles of portaging up to the Grand Portage, but decided that for 8.5 miles without a rest while paddling, I needed to double portage (one trip with the canoe, one with the pack). The fourth day I then paddled from Grand Portage to Grand Marais (37 miles) and biked back to my car (33 miles). Having completed that stretch in the middle, I have now paddled or portaged a continuous route from the west end of Lake Kabatogama in Voyageur's National Park to where the St. Croix River joins the Mississippi at Prescott, WI, a little over 600 miles. I'm always struck by the effect of having a goal or a must-do destination when there is no other way to get there.

My next adventure is to learn to kiteboard. Last summer I tried to learn to dance in anticipation of the wedding, but was unsuccessful. So like in the markets, sometimes I reach my goals and sometimes I don't.

Lee