Wenzel Analytics Inc

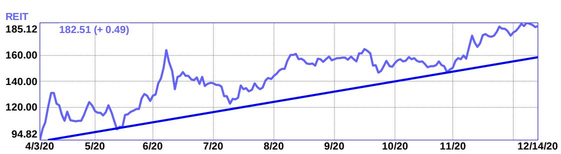
January 1, 2021

Elaboration on changes to the investing architecture

Clients,

When we look at our brokerage balances, we immediately look for the bottom line to judge whether it is up or down, and by how much. We give the number more weight than it deserves. It is a hypothetical number meaningful only if we sold everything today. It likely will be different tomorrow and quite different when we withdraw the money. Even if we were to sell today, the bid would be above or below the price of the last trade.

There are different ways to evaluate the current balance in an upward market. One step towards realism is to consider everything above a trend line as merely “chips on the table”. We can normally expect



markets to vacillate above a lower trendline. A drop below the trendline might be reason to sell and take money out of market vulnerability. Looking at the trendline gives a more realistic picture of value.

A better yet approach is to divide realized gains (and losses) from unrealized, monies received and “locked in” from mere valuations based on current prices. Locked in monies come from dividends, interest and sales. Profit or loss on sales are dependent upon when the stock is sold, and gains evaluated on how long it was held. Dividends on common stocks and real estate investment trusts (REITs) can vary each quarter depending on the dividend amount declared by the board of directors. The yield will then depend upon the current share price. In contrast, dividends on preferred stocks do not change throughout the life of the preferred stock. If we base the yield on our cost, the dividend stream in terms of dollars received is a constant and does not vary quarter to quarter. Rather than looking at current value based on price, we look at the rate of income.

In this market that is overextended in terms of valuations, looking defensively at locked-in income avoids some of the anxiety coming from anticipating the future downturn. For these reasons, I have gone to dividing performance more clearly between realized and unrealized gains, between locked-in and only partially locked in such as the variable dividends.

This refocus has resulted in an architectural change in how I view and structure investing and reporting. I still pay most attention to the criteria for grouping of stocks into portfolios, looking at individual stock selection only within that context. I have not added new portfolios but have discontinued portfolios that did not work in the context of very different dynamics than what usually characterizes an economic downturn. The economic downturn accompanying the pandemic has been met with an infusion of money supply creating an overvaluation of growth stocks.

Nate’s Notes was discontinued with the steep March decline except for Mannkind which has quadrupled since. The portfolio was mostly semi-conductors and biotech. The Momentum and Software as a Service (SAAS) portfolio was vacated this fall with the leveling off of overvalued growth stocks. The statistically derived Defensive portfolio was dropped when it clearly was not working given the unique drivers of the March downturn. The Consumer Staples portfolio held up well in March and April, but then showed little promise going forward. The initial result was moving to cash. Then with the market strength I moved money into the existing portfolios but positioned the portfolios within a new framework.

For nineteen years since beginning to manage money for other people, I have framed portfolios within the three methodologies of 1) a strong and persuasive rationale or story, 2) a statistical and data mining process or 3) drawing from a tested source such as a newsletter. The statistical approach is no longer working as it once did, presumably because of the

An alternative to mutual funds.

Lee Wenzel
(952) 944-2699
Lee@WenzelAnalytics.com
www.WenzelAnalytics.com

Wenzel Analytics, Inc.
Registered Investment Advisor
8666 Westwind Circle
Eden Prairie, MN 55344

C:\Users\Lee\Dropbox\WA\Client Files\Client Ltr 2020-Q4.docx, 1/3/2021 advanced artificial intelligence (AI) and extensive quantitative tools that have impacted the market. The Tested Source methodology was impacted by Mark Hulbert selling his independent newsletter evaluation service to MarketWatch, which then sold it to Rupert Murdoch and it was discontinued. As a result, the boundary between a tested resource and a merely credible resource became blurred. While I maintain the distinctions in my thinking and data, it is less dominant and no longer part of reporting.

The four goals framework of 1) exceeding the market, 2) exceeding a down market, 3) being independent of the market, and 4) matching the market has morphed into a new continuum and set of dichotomies.

The emotional fear of loss is the greatest irrational impediment to optimum investment returns. It is true for professionals as well as amateurs. Even the AI algorithms often reflect and magnify humans' fear. Rather than to think we can out-think fear, one of the best ways to control the fear response is to not view what precipitates the fear when there is no logical reason to see what causes the irrational fear.

To circle back, we buy preferred stocks primarily for their locked-in dividends. The gains on sale are frosting on the cake. Unless it has a fixed/float feature in the prospectus, a preferred stock pays the same dividend for as long as that preferred stock exists. A 6% dividend pays 6% times $25 ($1.50 per share) every year independent of the stock price. If we buy that stock at $20, our Yield on Cost (YoC) is 7.5% which continues coming into the account until we either sell the stock on the market or it is bought back (called) five or more years from the initial public offering (IPO). What we paid for it does not change and the dividend does not change. The only reasons to watch the price, which is what you pay me to do, is 1) to buy more, 2) to sell if the price is above $25 and we need to take the gain rather than risk the loss of having it called for $25, or 3) if a severe price decline points to a possible bankruptcy. If in our 6% dividend example, the preferred stock (or note) is called two years after we bought it for $20, we then have a gain of $5 on top of our dividends. Divided over two years that gives another 12.5% in gain each year for a total annual return of roughly 20%

This locked-in emphasis on realized rather than unrealized gains is like a rachet. With common stocks we may fear that a stock's price will go down, turning hoped for profits into a future loss. The dividends collected on preferred stocks will not be recalled. To that extent we are protected from the collapse of an over-valued and overextended market.

Think of eating dairy and cheese rather than beef. Think of eating eggs rather than poultry. We are taking it in as we go rather than anticipating an eventual killing.

In a defensive mode, almost half of what I manage for you is now in preferred stocks. Currently the Yield on Cost is 9.0% and the Yield to Call is 19.3%. The Yield-on-Call may happen if called when callable or may continue at the Yield-on-Cost for each of the seventy different preferred stocks. With preferred stocks we are consigning ourselves to the Yield-on-Cost returns with the Yield-on-Call being a bonus. No more suspense about a bear market. The reporting on preferred stocks is about cash returns from dividends while ignoring or minimizing price variations. Price variations are irrelevant to our goal of reliable income, and thus can be a false red flag.

On the Preferreds navigation bar of my website is more information about how preferred stocks work, tactics within the preferred strategy for varying the credit risk and returns, and for why this level of solid returns are available to us.

Be sure to contact me if you have questions or want to redirect the emphasis of your investments.

Sincerely,

Lee