# O'Shaughnessy Portfolio Added

Wenzel Analytics Inc

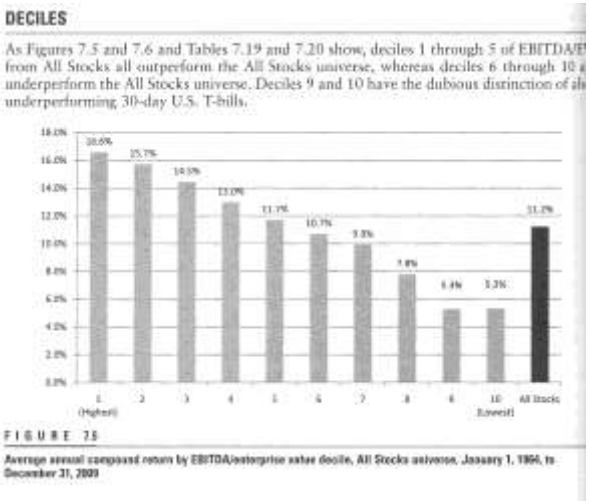
A core portfolio going forward will be based on the work of James P. O'Shaughnessy. Since this will be an important component of your holdings, I want to provide some detail and background. O'Shaughnessy was the primary influence twenty years ago in my adopting a data-based approach to investing that finds quantitative criteria that have worked in the past and then applies those criteria in selecting stocks. Since then I have used his methodology but not his data or screens. Now that is changing and I am using a screen he has researched and recommends.

The renewed interest started with listening to O'Shaughnessy's keynote address to the AAII National Conference last November. (I can send the audio file, handouts and PowerPoint if you are interested.) His data goes back to 1926 while most of my research goes back ten years or less. He has better tools for finding consistent returns. My software can find combinations of criteria that work over a given time period, but I need to individually review the consistency of each screen set of returns. Often most of the very high returns over an entire period occur during a very brief interval, thus skewing the reliability of results.

The O'Shaughnessys (father and son) promised the AAII audience that they would provide a recommended screen using the AAII database. This was published in the March issue of the *AAII Journal*. (www.aaii.com/journal/article/finding-value-and-financial-strength-based-on-what-works-on-wall-street) It was a rather tedious process to construct a spreadsheet to calculate the details given in the article. Some of the details are ambiguous and some are in conflict with O'Shaughnessy's book *What Works on Wall Street, Fourth Edition*. The data and conclusions in the book are very compelling. I would recommend getting it from the library if you sometimes make resolutions to better understand investing or what I am doing. Do not be intimidated by the data tables on most of the 650 pages. The first page and last couple pages of each chapter lay out the parameters and conclusions very decisively. The screen I am applying with very good results so far in your accounts is mostly from the *Journal* article and the book's Value Composite Two (page 582).

And what comprises the screen? Over time, value stocks outperform growth stocks, and smaller stocks outperform larger companies. In addition, stocks with upward momentum do better. Rather than to take a single metric of value, the best results come from combining measurements of value, financial strength and earnings quality. Value is measured by a combination of price to free cash flow, price to earnings, price to sales, enterprise value to earnings before interest, taxes, depreciation and amortization (EBITDA), and shareholder yield (dividends and stock buybacks). Financial strength is measured by a modest amount of debt and external financing such as taking on debt or issuing stock. Earnings quality is measured by the ratio of operating cash flow and net income to market cap.

The chart below is typical of how just one of these variables breaks out by deciles, in this case EBITDA. (Scan from page 120 of *What Works on Wall Street*.) (OVER)

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Instead of using their simple measurement of whether or not a stock has gone up in the last six months, I use the results of my research on stocks trending and their fractal dimension index. A stock's trend is mathematically measured by dividing the standard deviation (over the last 30 periods) by the simple moving average.

While there are periods of diminished returns, over time the results are persistent and significantly better than market returns. For the period from 1/1/1964 through 12/31/2009, $10,000 becomes $15,416,651 with a minimum ten-year annual return of 6.17% and a maximum ten-year return of 29.77%. (More details are on page 582.)

The O'Shaughnessy portfolio is 18% of the combination of all of your accounts. Buying commenced on March 5. The percent change to date is 11.4 %, while the Russell 3000 percent change is -.5%. Granted, that is a short time period. I plan to increase the allocation and to limit turnover.

The O'Shaughnessy portfolio will be a core portfolio and dominate most accounts. It has screens for measuring value stocks, financial health and earnings. This is combined with the statistical screens related to trend patterns, momentum and the Fractal Dimension Indicator. So the O'Shaughnessy screens cover the fundamentals using extensive research going back to 1926, and the statistical screens add the technical component based on weekly and monthly bars. In addition, final stock selection uses weights from the Stock Investor Pro AAII database for the Piotroski financial strength as well as the Navellier Quantitative and Qualitative grades.