Update on Stock Selection

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A. Current Methodology

1. Strategies and Portfolios

Almost since inception in 2002, portfolios fit into three types of strategies. A strong rational, logic, story or scenario drives the first strategy. Gold and silver comprise the dominant portfolio used on other people's money (OPM) within the Strong Rationale strategy. Some clients have chosen a passive portfolio of balanced index Exchange Traded Funds (ETFs). In my personal account I'm comfortable with more uncertainty and have a portfolio of Singles, or individual stocks and country ETFs selected from a variety of sources because of some specific appeal. I also have in my personal account a portfolio of energy-related stocks, looking for significant appreciation over a more prolonged time period.

A second strategy is to use newsletters and other sources selected because of their tested and empirical performance history. The current portfolios within the Tested Source strategy are High Income, Investor Advisory Service, Small Cap Informer, Nate's Notes and Shadow from AAII. When value stocks have begun to recover, we may go back to an O'Shaughnessy and other portfolios.

A third strategy derives from criteria developed or adapted using statistical and data mining technology. A somewhat detailed description of the methodology is at the website under Papers. The only current deployed statistically derived portfolio is Playing Defense. This screen best meets the challenges of finding consistent patterns even in down markets, and a count of selected stocks with incredibly consistent high one-year returns.

2. Final Stock Screening

After making selections for each portfolio, I look at several further qualifying criteria in creating a buy list for each portfolio. I usually look at the Fractal Dimension Index from a utility by Matt Trivisonno called Fractal Stock Grapher. I usually rate stocks using research on the coefficient of variation (standard deviation divided by moving average) and the Fractal Dimension Indicator built for me by XLQ as an Excel add-on. I nearly always score stocks on a composite consisting of the Piotroski Financial Strength indicator from the AAII *Stock Investor Pro*, the Navellier Quantitative grade and the Navellier Qualitative grade. I do a technical rating looking at charts over multiple time periods and looking for lines of support, resistance and retracement levels. I avoid stocks that march lockstep with the market, as that points to stocks movements dominated by index buying. One would buy indexes if one wants to merely keep pace with the market.

A different process is used for high income stocks. Preferred stocks are selected based on criteria such as price relative to the call price of $25, yield, time-to-call, cumulative dividends, domestic domicile, Fitch and S&P ratings and sector diversification. For REITs I prefer those in special markets such as senior housing, student housing, medical office and public storage since, with good management, they tend to be more independent of economic cycles if not counter-cyclical.

3. Client Allocation

Each household's accounts are individually balanced using these strategy and sub-set portfolio selections. Some portfolios work better in different market periods. Different clients holding the same portfolio will differ because of starting at different points in time and thus with different positions. Even at the same purchasing date and for the same portfolios in different accounts, the number of stocks added to a portfolio is dependent upon cash available and allocation considerations

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between different portfolios. Because the total of all accounts is more consistent than any given account, the aggregate report overall and on each portfolio is more relevant to expected future performance than the single sample of a client's individual report.

B. Summary of Conclusions

Any effort to describe my assumptions and approach to investing is going to necessarily be incomplete. Worse yet, I'm not even aware of many of my most basic assumptions. Here are some of the conclusions and principles that come to mind.

1. **It's more about strong criteria for portfolios than about picking individual stocks.**

   My orientation is to find varied criteria for different strategies, and then for portfolios within those strategies. My research is oriented towards finding strong criteria which will in turn find profitable stocks.

2. **Use systematic investing based on long history.**

   Buying based on replicable screening criteria that have had superior performance for fifteen or more years is more likely to give better returns than studies based on a more recent time period, or buying based on qualitative and subjective factors such as a convincing story of a growing, well-managed company with potential and a disruptive technology.

3. **Expect disappointing years.**

   Even the very best money managers and advisors have years in which returns are not only less than the market, but are negative.

4. **Indexes are not the average.**

   The average money manager, advisor, mutual fund and investor all have performance below the indexes. Obviously the indexes are not average and have built-in mechanisms that produce higher stated returns. First of all, indexes themselves are not investable. Someone has to construct and market a product based on an index, adding license fees, management costs and transaction costs. Secondly, indexes have built in mechanisms that reflect momentum and often do not reflect shifts in composition that would mean high and expensive turnover if buying the individual stocks. If a stock drops out of an index, say with a 20% drop in price, that loss may not be reflected in the index but would be reflected if an active manager held that stock.

5. **Index buying itself has a profound impact on stock prices.**

   a. Stock markets – like any auction – are affected when buyers will bid whatever it takes to win the auction. When investors buy SPY, the largest of the index Exchange Traded Funds (ETFs), that money buys each of the 500 stocks in the S&P 500 regardless of the merits – however judged – of each individual stock.

   b. These interconnections are the mechanism that causes stocks to correlate so closely.

   c. Most stock price movements, especially in the shorter-term, are impacted much more by the aggregate amount of money flowing into or out of equities than by the productivity of the company or the wisdom of its executives.

   d. Buying of indexed products, which is prudent at the individual or micro-economics level has deleterious effects at the aggregate or macro-economic level. This system of socialized capitalism results in capital not being allocated to the most productive enterprises. In state-run enterprises, at least someone or some group is endeavoring to manage and make rational decisions regarding capital flows.

   e. The financial services industry and related industries such as financial newsletters and media have strong incentives to not reveal or even see the true dynamics of the market.

f. It is very difficult to escape the impact index funds have on stock prices. Stocks too small to be in an index are difficult to trade because of insufficient liquidity. To look outside publically traded securities and buy individual private companies is much more complex, especially with IRA accounts. To buy stocks with the lowest market correlations is counterproductive, as they miss the buying pressure and boost from funds coming into the equity market. For stocks to rise or fall dramatically, it takes special events that attract investors far in excess of index actions. These events are difficult to forecast without inside information.

6. **Not all clients want to do better than market benchmarks.**

   Even the most aggressive investors need a reliable solid core of income for living expenses. As we get older, that usually shifts from wages to sources such as Social Security, maybe a pension, interest and dividends. A consistent and reliable source of income for living expenses is important regardless and independent of market fluctuations. Beating the market is important for long-term investing and after the assurance of basic income security.

7. **Markets are fractal rather than random or normally distributed.**

   Markets do not conform to a normal distribution and a bell-shaped curve. Therefore, normal Gaussian statistics including standard deviations as a measure of risk are not accurate. If markets were random, they would be much more predictable. Rather, markets are fractal, meaning that there are self-similar patterns nested within patterns – like small waves riding on bigger waves riding on bigger waves. To make things even more unpredictable, there are many Fractal Dimension Indicator formulas in use, and not all of them are useful.

8. **Many clients will leave after a year or two of disappointing returns.**

   They will select another product or advisor that has done better recently, but is likely to do worse going forward.

9. **Wholesale market timing in response to actual or feared declines of 10%, and maybe even 20%, is very difficult to do successfully.**

   The reason to exit the market at a proscribed level, say when it declines 20%, is not because of the probabilities of the market being lower say a month or two months forward, but rather because one cannot tolerate the risk of being in that kind of a volatile market.

10. **Macro-economic forces are very hard to time and profitably find relevant investment vehicles.**

    Bonds may be a risky investment, but even the timetable on probable interest rate changes is hard to know. Central banks may have a big role in equity prices, but how do you make money on that belief or opinion unless you profit from writing a story for a media outlet of some kind? A lot of opinion about the future of the economy presumes some kind of implicit relationship between the economy and the price of stocks. Often that relationship is very complex and not consistent.

11. **Value stocks have better return probabilities than growth stocks.**

    While value stocks overall give better returns, they are not nearly as interesting and the stories are not nearly as engaging as for growth stocks. When growth stock indexes do outperform, it is usually the result of a relatively few stocks which are hard to anticipate.

12. **There is little consensus on basic principles within the financial services industry.**

    Most professions typically have a basic set of principles that guide professional practice. There are few if any such principles in financial management. What one professional takes as a given, someone else can find reasons to take the opposite position. Should one diversify? Warren Buffet says why not put your money in the few investments one knows to be exceptional. Obviously, one can't know a lot about every company. Should ones allocation change as one gets older and retires? Many say investors should move more towards bonds and fixed income with age. However, many people need to take on more risk in order to possibly augment their retirement accounts. Many others have more money than they need for their lifestyle, and the balance which will go to heirs, charities or the government should be optimally invested quite independent of the owner's age.

13. Very few financial services providers work for their clients' best interest rather than their own.

The field is filled with charlatans. Beware. Look at the incentives and the safeguards. Some people trust large institutions. I call them domestic animals. Some people distrust large institutions, especially financial institutions, and do due diligence in trusting their own judgment and an individual manager. They are more likely to be wild animals that live outside the fences.