April 3, 2015

Each quarter, I like to provide a short and clear, informative summation about investments to replace the vast noise that emanates from the media and financial services industry. Unfortunately this letter will not be as simple or as short as normal due to the current challenging investment climate.

During this first quarter, a number of world conflicts reached a critical point, which impacted the investment performance of portfolios managed by New West Investment Management, Inc. These included Greece versus Germany (as a proxy for the European Community) regarding the formers repudiation of the terms of a previous debt restructuring deal as well as the competitive currency depreciation battle being waged between the United States and Europe.

In 2012 the European Central Bank (ECB) pledged to do whatever it takes to stimulate the economy and stabilize the banking system to protect banks in the Eurozone. In January the ECB thus embarked on a “quantitative easing” program whereby they purchase member nation bonds in a fashion similar to the approach used by the U.S. Federal Reserve Bank (Fed). A significant difference in the programs is that while the Fed purchased U.S. backed bonds and mortgage securities in an attempt to hold down interest rates, the ECB is buying bonds that offer a negative return.

The effect has likely immunized the markets and protected the banks in the short run from a possible debt default or withdrawal from the Euro by Greece. The resulting decline in value of the Euro compared to the dollar provides a competitive advantage to European companies. Hence, the large U.S. multinational stocks within New West managed portfolios were breakeven at best during the first quarter. Negative European interest rates also kept a lid on U.S. interest rates, minimizing potential returns on portfolio bond holdings.

As the dominant producer in OPEC, Saudi Arabia continues its onslaught against unconventional North American oil producers. While prices decline due to increased supply generated in North America, the Saudis are holding petroleum production steady which is disrupting the economics of U.S. shale oil drilling, global offshore oil production, and the budgets of major energy producers such as Russia, Venezuela and numerous Middle Eastern countries.

Meanwhile, the Sunni vs. Shiite struggle escalated beyond Iraq as the Saudis built a Sunni coalition to attack Iran-supported Shiite rebels that overthrew the Yemen government. These developments could reflect the United States moving to strengthen its relationship with Iran at the expense of Israel and Saudi Arabia. While the shifting of alliances by the United States is nothing new, the current adjustment could have a negative or positive impact on oil prices going forward. To the extent that a nuclear non-proliferation deal with Iran leads to Iranian oil returning to the market (as if it is not already being sold back channel), prices could decline further. However, the increased fighting involving previously stable regimes could lead to production or delivery disruption resulting in higher prices.

While historically I have not been a big fan of investing in energy holdings, I have increased my exposure of late with an eye toward oil prices stabilizing at a higher level in the mid to longer term. The cost has been a hit to investment performance in the quarter, although I will continue to position energy holdings opportunistically.

Finally, as far as I am concerned, the granddaddy of all wars is the “Man versus Machines” battle that pits active investment portfolio managers such as myself (Man) against passive strategies, computer algorithms, robo-advisors and central planners (the central bankers of the world) (Machines). The reason this contest matters is that recently Man has been coming up short as compared to the Machines and I want to make clear why I think it is important to continue to skillfully fight instead of surrender.

The idea of passive investing based on the "efficient market theory" (buy a diversified, unmanaged portfolio of securities without regard to price or quality and hold them with occasional rebalancing) started with a doctoral thesis by Eugene F. Fama in 1965. The concept presumes that investment markets are so complex and competitive that no amount of analysis adds to investment performance so investing in an automated fashion like a machine (without thinking) is the best approach. The theory has gained popularity with the likes of Burton G. Malkiel of Princeton University and John C. Bogle, founder of the Vanguard Group being key apostles.

The problem with the theory is that it relies on free riding on the work and analysis of others. The markets are "efficient" due to competition for the best returns by purchasing better quality companies at lower prices; said another way, because of thinking participants. As more investors adopt a machine approach, the value of thinking may seem to be a waste of time, but it will at certain points add tremendous value. Recent examples of points when thinking added value are prior to the tech & telecom bubble and the real estate bubble market collapses.

Computer algorithms are programs written to automatically trade stocks or other investments based on a recipe of what has worked historically to sort out winning investments from losing ones. Though there is thinking that occurs in the initial construction and periodic tweaking of the programs, it stops there. When the attributes of winning and losing investments gain acceptance over time and are adopted by more programmers, the approach can go from successful to destructive. The Long Term Capital failure in the late 90's is the best example of the many instances of the breakdown of this type of relational investing.

Brokerage firms, financial services companies and numerous web sites have recently introduced what are being referred to as "Robo-Advisor" services. After requiring prospective investors to input information and opinions, a computer program creates a plan, offers advice and even provides portfolio management for a fee. I am all for using technology to improve results and performance, however I am not interested in turning my financial wellbeing over to what could turn out to be HAL from 2001: A Space Odyssey, a run away intelligent computer without understanding of the nuanced, ever fluctuating investment climate.

The central bankers of the world have also become something of a machine over my 30-year investing career. What started with Alan Greenspan cutting interest rates and flooding the markets with liquidity in response to the Black Monday stock market crash of 1987 has evolved (devolved) into a global system of central bankers reducing interest rates to support economic growth when recessions arrive. These Central Bank manipulations of interest rates and liquidity added to the market bubbles in advance of the stock market crashes of 2000 and 2008 and are likely creating distortions now. With interest rates at zero in the U.S. coupled with the Federal Reserve's reluctance to normalize them, even 6 years into an economic expansion, and the European Central Bank trying to force interest rates further into negative territory, this machine is likely broken and may be exposed like the king with no clothes in the next recession.

I'm aware that thoughtless machine investing is generating better returns with less effort in the current investment market environment than the studied approach I use in managing your portfolio at New West Investment. In fact, during 2014 all net new contributions to U.S. stock funds were placed into passive investment portfolio strategies, so many investors are aware as well. With most sectors tracking together due to indexing (passive investing) and few market pullbacks due to TINA ("there is no alternative" to stocks because of low interest rates) the value of asset allocation (being less than fully invested in the stock market) and security selection (thinking) is not now apparent.

But there are signs that the "man versus machine" pendulum has swung too far in favor of the machines and that thinking will again add value to portfolio management. Aside from the corner that central bankers have painted themselves into mentioned above there are other indications.

Robert J. Shiller, a behavioral economist with Yale University and 2013 recipient of the Nobel Prize for Economics has recently updated his book "Irrational Exuberance" that was first published before, and forecast, the Tech & Telecomm crash of 2000. A perceptive chapter was added in the 2005 edition on the excesses in the real estate market, and the current edition outlines the likely overvaluations in the stock and bond markets now. While he makes no claim of being able to calculate the timing of market corrections, he is on record regarding his expectations that stock market returns over the next decade from current levels will disappoint. I have enclosed a recent article outlining his views.

An additional contrary indicator is that John C. Bogle, referenced above, was recently quoted as predicting the end of the active portfolio management industry. His comments may signal a change in environment as did the Business Week article in 1979 that predicted "The Death of Equities" before a better than 1,800% rise in the Standard & Poors 500 stock index over the next 35 years, or Time Magazine naming Jeff Bezos of Amazon "Man of the Year for 1999" with the stock subsequently declining 94% over the next 24 months, or The Economist cover in 2003 proclaiming "The End of the Oil Age" when the price was in the $20 to $30 per barrel range on its way to over $140 per barrel by 2008. Hyperbole is a sign that the winds of change are coming.

To summarize, the trifecta of the strong dollar's negative impact on the value of large multinational stocks, the continuing weakness in oil prices hitting energy stocks, and the amount of underinvested funds earning little in New West portfolios has caused investment performance in some client accounts to lag behind fully invested stock indices recently. Said another way, my thinking about not only the potential gains of making an investment but also the risk of loss given the elevated valuations of many investments has been a drag on recent investment results. However, I am confident that using a thoughtful, engaged approach to managing portfolios will again be a value-adding proposition.

I'll close with an excerpt from the 1988 Berkshire Hathaway Shareholder Letter in which Warren Buffett provides some thoughts on "efficient market theory" (EMT).

> *Amazingly, EMT was embraced not only by academics, but by many investment professionals and corporate managers as well. Observing correctly that the market was frequently efficient, they went on to conclude incorrectly that it was always efficient. The difference between these propositions is night and day.*
>
> *Naturally the disservice done students and gullible investment professionals who have swallowed EMT has been an extraordinary service to us and other followers of Graham. In any sort of a contest - financial, mental, or physical - it's an enormous advantage to have opponents who have been taught that it's useless to even try. From a selfish point of view, Grahamites should probably endow chairs to ensure the perpetual teaching of EMT.*
>
> *Remarkably, you'll find EMT taught to this day at respected universities and colleges.*

Enclosed please find your portfolio report covering the periods through the first quarter of 2015 and an invoice, if applicable. Please feel welcome to contact me if you have any comments, questions or items that you would like to discuss personally.

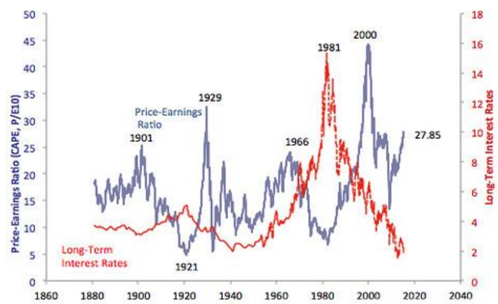
Best regards,

Peter V. Hedberg

Why Robert Shiller is calling this U.S. stock market ‘a great enigma’

Published: Apr 2, 2015 9:58 a.m. ET

CAPE ratio is at levels last seen in 2007



Getty Images

Robert Shiller is puzzled by this stock market.

By ANORA MAHMUDOVA REPORTER

NEW YORK (MarketWatch) — Confounded by this wacky stock market? You’re not alone. Robert Shiller, the 69-year-old acclaimed economist who helped create the Case-Shiller home-price index, is having a tough time deciphering this U.S. stock market too.

The 2013 Nobel laureate and Yale University economics professor told MarketWatch that this volatile, post-financial-crisis market, in which interest rates have been at or near zero since 2008, is “a great enigma.”

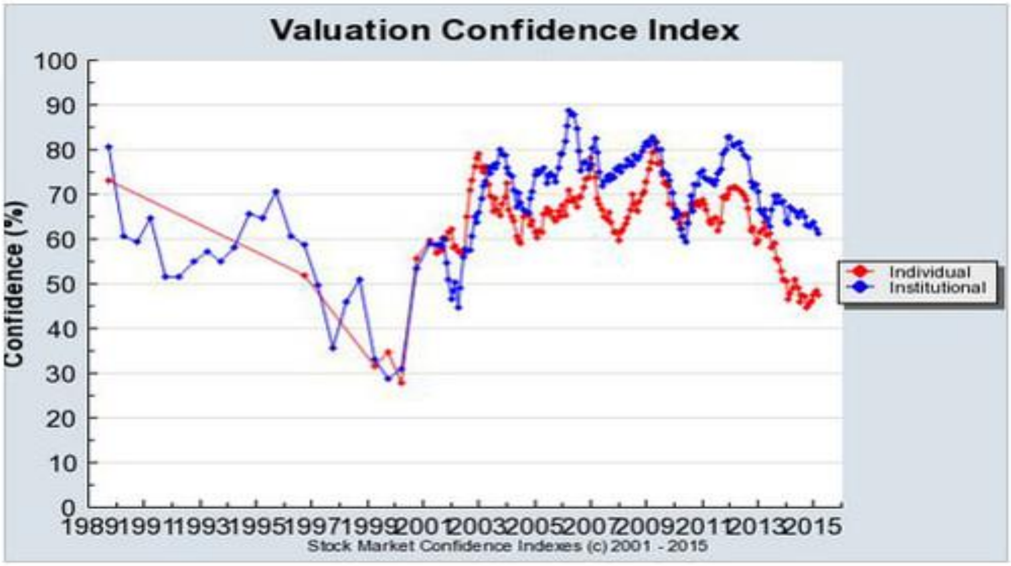
So far, stock prices haven’t buckled in the face of falling earnings and signs the U.S. economy has been slowing, while the Federal Reserve is hinting at a rate hike as early as June. But they haven’t exactly been stellar either. The S&P 500 fell 0.4% on Wednesday and is now flat for the year.

“This stock market is an enigma,” Shiller said. “Short-run forecasts are very difficult. But analyzing historical data taking into account cyclical adjustment, we can calculate long-term returns,” Shiller said, referring to the Cyclically Adjusted Price-to-Earnings ratio. The CAPE ratio is the ratio of the S&P 500 index to trailing 10-year average earnings, and to some, including Shiller, it has been signaling that stocks are overvalued.

And even despite these lofty levels in stocks, Shiller sees reasons why the market could still stumble higher. “When CAPE was this high (at nearly 28), 10-year returns on the S&P 500 are nearly flat, because inevitably there is a major correction,” he noted.

“While history suggests current levels signal a correction, it does not mean we will have one soon. CAPE could go higher, as it did in 2000, so until then, stocks could keep rising,” he said. In other words, Shiller thinks the market could become unhinged at some point, but when that is going to happen is anyone’s guess.

“The problem is, you cannot time [a correction] precisely,” he said. But it isn’t just the CAPE ratio that is bothering Shiller. The Yale International Center for Finance runs several surveys gauging confidence in the stock market, and the fact that the so-called valuation confidence index has been dropping over the past year is also making Shiller nervous. “When valuation confidence falls, it means that stock markets are perceived as overpriced,” he said.



Shiller isn't alone in his nervousness about valuations. Prominent Wall Street tycoon Sam Zell told CNBC during a Wednesday TV interview that he believes that "there's a significant and growing disparity between the stock market and the economy."

Shiller is a behavioral economist and considers market movements a social epidemic. He explains that once people begin talking and ideas spread, prices destabilize. Shiller goes into more detail about that in his book "Irrational Exuberance," which was recently revised and expanded.

As for his own investments, Shiller said he reduced his stock holdings in light of various indicators, but that does not mean he has abandoned equities. But he is hedging his bets. He told MarketWatch that he's purchased an oil ETF. Shiller said few understand the value of commodities like oil as an asset class. "It is uncorrelated to stocks, and prices are low. But if you look at oil-futures contracts, they indicate that prices will be higher," the economist noted, referring to forward-month contracts.

Higher oil, overvalued stocks? Ultimately, it all sounds like a recipe for more turbulence.