April 3, 2017

The domestic investment markets generated positive results in the first quarter. Bonds provided a return of 0.5% to 2.7%, with higher credit risk issuers delivering a higher return. This even as the Federal Reserve increased interest rates 25 basis points (1/4 of 1%) during their March meeting. Regarding equities, small stocks underperformed mid-sized stocks, which underperformed large stocks, with total returns from 2.5% to 6.4% respectively based on capitalization.

New West Investment portfolios advanced approximately 2.2% on average in the period. Individual stock holdings returned about 3.5% including dividends, due to representation in all capitalizations and a heavier weighting to value as compared to growth issues (more on this below). Bond holdings being predominately low credit risk U.S. Government securities added 0.5% to portfolio returns. All categories of mutual funds were positive, contributing around 4.3% through quarter's end, while cash was a bit positive.

On an absolute return basis gaining 2.2% per quarter is a satisfactory result, particularly in the current investment environment. In fact, that exceeds the 2.0% average quarterly total return for long standing New West Investment clients. This compares favorably with the 2.3% average quarterly total return for the Russell Top 200 index (similar to the S&P 500) since 1991.

More importantly, these returns also met all of my client's investment needs, doubling the value of a portfolio over an eight-year span, keeping up with equity market indices over the long term, allowing for sustainable withdrawals from a portfolio during retirement while providing principle protection in the event of market declines.

That said I am suffering some frustration when seeking to find reasonably valued stock investment opportunities. I would like to add to equity allocations for clients that have larger cash positions and would also replace some holdings that are not progressing as well as I had envisioned. In 2015 and 2016 there were market selloffs in the 10%+ range during the year as well as volatility by various industry groups. This allowed for a decent number of reasonably priced investment ideas to be added to portfolios.

However, during the first quarter the stock market was up trending and non-volatile (smallest average daily market % move in 50 years) with the industries that fared the worst being retail and energy. Both groups are suffering from a significant over investment of capital during this economic cycle, likely due to excess liquidity created by the Fed, combined with newer disruptive technologies. I have some exposure to these industries in client accounts and was looking to add more on price weakness, but could not justify further investment at this time for the reasons outlined below.

Retailers of all types, including department, discount, grocery and restaurant, have added too many locations as an excess of stores have been constructed. Industry problems have been compounded by the disruption caused by online sellers. Online retailers have been able to cut prices and win sales due to advancements in Internet technology and investor willingness to accept a much lower return on invested capital as compared to traditional retailers. This has driven down the return on capital of brick and mortar retailers, which will likely continue, much as it did in the newspaper industry.

Oil prices have declined from over $100 a barrel in 2014 to a current level of $50, up from under $30 a year ago. This kind of volatility would normally create investment opportunity, and it has to an extent. However a recent doubling of U.S. drilling activity has hampered the recovery in oil prices. Again credit availability combined with the rapid project development allowed by modern horizontal drilling and fracing has stalled a price recovery and reduced or eliminated the return on invested capital.

I point out these two industry situations to highlight a couple of factors. First, excess capital in an industry or economy forces down the return on invested capital. Central banks have flooded the global economy with capital, elevating asset prices and lowering the return on invested capital. Second, new technology can disrupt the return on both capital and labor as computers and robotics make some structures and jobs obsolete.

Examples of excess capital and innovation suppressing returns on capital are the tech and telecomm boom of the late 90's and the real estate bubble of the mid 00's. A more recent illustration, and on a smaller scale was the energy bust in 2015. My job is to avoid these situations as best possible to protect investor's principle.

As a reminder, what I mainly look for when investing in a company's stock is 1) an attractive return on invested capital 2) for that return to be sustainable and 3) an attractive entry price based on the company's free cash flow. This last item is what puts me in what is known as the value investor category. Growth investors are less or not concerned with the price paid for an investment, figuring that long-term growth will make any price paid reasonable at some point.

In the most recent quarter growth out performed value as companies like Apple, Amazon and Facebook advanced 25%, 17% and 24% respectively. Because they are ranked 1, 4 and 7 in the S&P 500 they have a 3.5%, 1.6% and 1.6% weighting in the index, skewing performance upward. In my opinion underlying fundamentals do not support the stock prices of Amazon or Facebook. It is just the supply and demand of a persistently hot investment theme that levitates their price. If you want to play online shopping the only game is Amazon, if you want social media it is Facebook or go home.

When assets prices get too far ahead of the underlying economic fundamentals of the business, there is an increased risk of permanent loss of capital and reduced return potential going forward. I would say that Amazon at 181 times and Facebook at 44 times last year's earnings are ahead of themselves, especially when compared to the current historically high 26 times earnings for the S&P 500 index. The mean and median for the U.S. stock market is 14-16 times earnings, ranging from 1870 to today.

How did we get to such extended valuations? According to James Grant of Grant's Interest Rate Observer, from the stock market cycle bottom on March 9, 2009 to March 9, 2017 the price of the S&P 500 total return index advanced 5 times the underlying companies' earnings. Before you yell, "sell everything", realize that it is a market of stocks. In the 4th and 1st quarter I purchased or added to holdings in the drug distribution business, CVS Health and McKesson, which have nice returns on capital, sustainable expanding businesses and are not economically sensitive for 14 and 10 times earnings respectively.

So there are attractive investments to be had if one is patient while sorting through potential candidates. The last time I got impatient I purchased some oil stocks in 2014 and 2015, which was not a good idea. I have included an article from Barron's Magazine with this letter that covers value versus growth investing, why it is hard to stick to value investing and the importance of being patient.

A number of my clients have queried me about my thoughts on market timing, the high valuations in the stock market and the state of affairs in Washington.

I don't call the changes I make in asset allocation (portfolio exposure to cash, bonds and stocks) market timing. I instead start with a weighting for each asset class based on my estimation of a client's ability to withstand a decline in account value both financially and emotionally, and then modify that based on my ability to find investments within an asset class at a price that I would invest my own money at. The effect is to help clients stick with their investments with the intention to hold more of an asset class when valuations are low and less when valuations are high; buy low, sell high. I enclosed an article that I recently read on the benefits of creating a diversified portfolio in the context of being prepared for stock market declines.

On the topic of high valuations in the stock market, simply said, all asset prices are currently elevated. It has been the Federal Reserve Board's stated objective to stimulate the economy "by keeping asset prices higher than they otherwise would be". They have succeeded. Interest rates on money market and bond investments are way below historic norms, real estate prices have advanced significantly in the last eight years and as I touched on above, stock valuations are full.

Also of concern, unrelated to high stock market valuations, is that in order to get the U.S. economy to grow, as measured by GDP (gross domestic product), from $14.5 trillion to $20.0 trillion annually over the last 10 years, U.S. Federal Government debt was increased from $8.8 trillion to $20.0 trillion. Furthermore, with interest rates still so low, the impact of the Fed cutting rates to mitigate the severity of the next recession may well be muted. However, most severe and extended stock market declines coincide with large increases in interest rates and/or economic recessions. Neither of these pre-conditions is currently at all apparent.

Finally Washington. I try not to pay too close attention to politics, it can steer you wrong when making investment decisions as I have outlined in a recent quarterly letter. I have issues with both political parties as our officials are often elected after making promises to give something to their constituents that they don't have to pay for. This increases debt to a level that at some point will be unsustainable and laid at our children's feet. To top it off, they need to be attentive to corporate interests to get elected and then have to follow the party line to be relevant while in office.

The protection against the issues above is gridlock, as appears was the intention of the founding fathers. I have been assuming congressional infighting would neutralize some of the extreme rhetoric presented by the administration thereby limiting the election's impact on the economy or the investment markets. Recent action on the AHCA seems to have validated that assumption. While I would like the healthcare payment and incentive system to be improved from its current state, as well as have the sustainability problems with Social security addressed, I have little faith that the government is up to the task at this point with only their political interests as a guidepost.

The stock market has run up in the excitement of political promises and prices will need to be supported by either stronger economic growth or corporate earnings. The good news is both seem to be in the offing at least in a small way.

As required by regulatory authorities, New West Investment Management, Inc. has updated Form ADV Parts 1 and 2, A & B for year-end 2016. Please recall in last quarter's letter, we notified you that we were revising client management fees. Because this is considered a material change, we have updated and amended our fee structure documentation with FINRA and enclosed a courtesy client copy of the materials change in this packet. You can review the complete current version at www.adviserinfo.sec.gov or contact our office, if you prefer that we send you a copy. You will also find your most recent investment portfolio report enclosed. Please feel free to reach out to me if you have questions or concerns.

Best regards,

Peter V. Hedberg