July 8, 2008

Client
Address
City

Dear Client;

Seems like every quarter provides a new crisis. A year ago it was the easy lending and narrow risk premium crisis that was only an issue if you were a money manager looking for investments as the stock markets hit new record highs. Then there was the bond investor crisis, as in "Oh my god, what did I invest in?" We missed that one except for collateral damage. In the first quarter of this year it was the banking crisis and in the just completed quarter it was the commodity crisis. The current quarter will probably provide the election crisis and the one after that, who knows? The whole thing can be a bit tiring and depressing.

But focusing on short-term disruptions that one has no control over is always a recipe for unhappiness. So I decided to look longer term and came across what those in the financial planning industry have come to call "The Lost Decade". "The Lost Decade" is a bad news, good news story. The bad news is that investment returns in most asset classes over the last decade have been very unsatisfying. The good news is that I'm going to make a case why the next decade could be much better. And since we can only work with the future, and we are well positioned to take advantage of the current market weakness, this story can have a happy ending.

First a review of investment returns over the last 10 years. As of June 30, 2008 the following asset classes provided the following annualized total returns (total returns include interest and dividends earned plus or minus gains or losses, realized and unrealized).

U.S. Treasury	Bills, 90 day	3.67%	Notes, 5 year	5.32%	Bonds, 30 year	6.67%
Russell U.S. Stocks	Top 200	1.83%	Mid-cap	8.12%	2000 small-cap	5.54%
Popular U.S. Indices	Dow Jones	2.40%	S&P 500	2.88%	NASDAQ	1.93%
MSCI Barra Developed Non-U.S. Markets			4.23%	MSCI Barra Emerging Markets		12.64%

As you can see only the Emerging Markets index provided double-digit returns per year over the decade and it is interesting to note that June of 1998 was right in the teeth of the Asian Contagion and the Russian debt default. So if you bought when there was absolute panic you made a decent return. "The lost decade" idea comes from the Popular U.S. Stock Indices failing to beat inflation over the last ten years.

I reviewed the 17 accounts that I have managed over the last decade and find the following. My best account returned 8.18% per year and my worst account 4.39%, with a simple average (not weighted by asset size) of 5.82% annualized return. Four portfolios returned less than 5.00% annually while seven returned above 6.00% annually. These returns are before my fee but after all commissions and other expenses. I am not inclined to brag about returns that are not above 10% annualized, and in fact I am disappointed with the results, however these accounts on average out performed inflation, U.S. Treasury Bills (think money market mutual funds) and Notes, Large and Small Capitalization U.S. stocks, the Popular U.S. Stock indices and Developed Non-U.S. markets. Also, these returns were generated with significantly less portfolio value volatility than the equity markets, no small issue. Before you think, why am I paying this guy, please keep in mind that returns always look bad when measured in a bear market, as is now the case.

What then should we expect for returns from different asset classes. According to the Ibbotson SBBI 2008 Yearbook, covering periods from 1/1/1926 to 12/31/2007 we get the following benchmarks. Compounded annual total returns for U.S. Treasury Bills, 3.7%; U.S. Treasury Notes, 5.3%; U.S.

Treasury Bonds, 5.5%; Long-term Corporate Bonds, 5.9%; Small Company Stocks, 12.5% and Large Company Stocks, 10.4% versus Inflation of 3.0% annually.

Some observations on the above: U.S. Treasury Bills barely outperformed inflation before taxes and therefore should only be used for funds that are to; be spent in the near term, buffer investment returns or as a weigh station while looking for better alternatives. The current return on this type of holding is about 2% annually. U.S. Treasury Notes and Bonds do somewhat better over the long term and are currently paying around the inflation rate, between 3.5% and 4.75%. Bill Gross of PIMCO, a noted, successful bond portfolio manager says U.S. Treasury Bonds are now the most over valued security in the world. What is clear is if one wants to build wealth over time there needs to be exposure to the stock market, business ownership or real estate ownership. The problem then becomes can we handle the short-term downside variations in the returns. To answer that, it is important to look at negative return variations over the last 82 years.

In 23 years, 28% of the time, or about 1 year in 4, the S&P 500 provided negative returns on a calendar basis. For 13 one-year periods the losses were between 0-10%, for 5 one-year periods 10-20%, for 3 one-year periods 20-30%, for 1 one-year period 30-40% and for 1 one-year period 40-50%. Three of the worst five years were during the great depression. Only four times were negative years strung together; The Great Depression 1929-32 with a total loss in the 80% range, World War II 1939-41 with a total decline of 20%+, The Inflation Years 1973-74 with a combine 40%+ loss and the Internet Bubble Collapse 2000-02 also down 40%+. The rest of the declines were single year events in the 0-10% range, 1937 being the lone exception. It is interesting to note that if you purchased stocks at the beginning of the first year of these multi-years declines after 10 years you still made money except in the Great Depression where you were down less than 1% annually for the decade.

So the stock market often has a 10% decline in a year and then returns to an upward path, a risk our portfolios can handle. However, given the above, we must be ever vigilant to manage portfolios considering periods like the four serious calamities of the last 82 years. Are we in such a period now? I don’t think so because in the three worst serious downside periods, stocks started at extremely high valuations on a historic as well as on a relative basis. Entering the current disruption valuations were in the median range historically and inexpensive compared to other asset classes. But if we are in such a period, the pain is probably halfway over and we only have a setback of a couple of percent in most cases from the beginning of 2007; not the end of the world. So we need to stick with the program and even add to our stock holdings over the next year. The best time to add to stock holdings is during times of severe concern. I think the current situation qualifies.

The just completed June saw the worst monthly sell-off since September of 2002. The incessant, and I think irrational, rise in oil prices sucked all the air out of the room. But more importantly, investment markets lie at the confluence of economics and emotion. While there were no new developments to explain the stock market’s declines, there is now significant economic and political uncertainty that has lead to extreme negative investment emotions. These types of investment environments lead to an increased incidence of mispriced assets, which spells opportunity because mankind has trouble sustaining these extreme emotional levels for long. That helps explain why most recessions and bear markets last from six to eighteen months.

Returns for the first half of the year were negative for almost all equity type investments with the exception of those tied in some way to energy and commodities. Corporate bonds were a bit negative as government bonds were a bit positive in the first half of the year. In short, there was not much to smile about. Please review the following stock indices for comparison to your portfolio outlined in the enclosed report.

Popular U.S. Indices	Dow Jones	-14.40%	S&P 500	-11.90%	NASDAQ	-13.50%
MSCI Barra Developed Non-U.S. Markets		-11.40	MSCI Barra Emerging Markets	-12.70%		

I managed to avoid most of the problems in the 2000-'02 market decline by having minimal exposure to the toxic areas, large cap, technology and telecom stocks, and as a result actually had positive investment performance through that period. I have had less luck in avoiding issues this time with a market weighting in financials and a minimal exposure to energy and commodity related companies. I had, and have, reasons for the positioning but did not foresee the extremes that have occurred in each area. In fact I believe that if the problems in the financials are as severe as the stock prices predict then energy and commodity usage will most likely go into the tank and hurt those sectors next. While this has caused me angst and hurt my equity performance versus the indices, to reverse these positions now would likely create the opportunity to hurt my clients and myself again. The positive related to current portfolio positioning is that I have ample cash and short-term bond holdings that can be converted into money making stock investments, of which there are many.

Stocks are attractive at this point because the free cash flow yield on stocks (the ability for companies to pay dividends) are significantly above bond yields, stock prices have substantially under performed the underlying businesses for the last decade, stock returns have been so lousy over the last decade relative to other asset classes as outlined above, investor sentiment is terrible, there has been an increase in corporate strategic acquisitions and there are many attractive opportunities across many industries. Finally, we can't get to where we need and want to be financially sitting in cash and bonds.

I see it as my job to help provide for and/or preserve my client's financial independence. In order to do so it is important to stay with what will work over the appropriate time horizon. A great investor once said "that to make money in stocks, you have to stick with them". These letters are much longer when the market is down as it takes many more words to convey why I think it is important to stay with the program when performance is negative as compared to positive. It is also important to keep in mind that things in the economy don't need to start getting better for the equity markets to improve, they just need to stop getting worse, or get worse at a slower rate. A rule for achieving above average returns is to buy during troubled times, recessions and bear markets.

I am mailing this letter, the enclosed portfolio report and invoice as quickly as possible so as to get this information in your hands where it may help offset some of the terrible news flow that we see, hear and read. I will be calling or meeting with you over the quarter to address how the current situation applies to each of you. Please keep in mind that at New West Investment Management, Inc. we "eat our own cooking" so the results that I am delivering are the same as what I'm receiving. Said another way, if I'm buying it for you I'm probably buying it for me.

Please visit our web site at www.NewWestInvestment.com, which is under construction, where there is a link to my blog, a collection of thoughts on general economic and market items as well as information of individual holdings or, as always, please feel free to call.

Best regards,

Peter V. Hedberg

P.S. The enclosed portfolio report has an adjustment from the first quarter report. In the first quarter Treasury Bill returns were mistakenly reported as 3.36% when in fact the returns were only 0.84%. You would notice this adjustment if you compared this report with the previous report.