July 6, 2015

In the past, I have used New West Investment quarterly letters to review recent market and portfolio performance as well as provide some insights into my expectations and concerns regarding the current investment environment. I have tried to make it clear that while I pay attention to macro level items like interest rates, the economy, and government policy (known as a “top down” approach), at the core I make investment decisions based on research focused on individual companies or issuers and the various securities available (a “bottom up” approach).

Another foundational principle of my investment process is that the price paid for an investment is as important as the quality of the asset in determining the eventual return earned. This sensitivity to the price paid has led me to seek out attractive assets that are currently out of favor, providing an inexpensive entry point using appropriate measures, due to company, industry or market concerns. This approach is known as “value investing” though, since I invest my client’s funds as I do my own, I like to think of it as careful shopping. I outline the above because while I put the most weight when making investment decisions on bottom up research, I write most often in quarterly letters about top down topics.

Going forward I will continue to cover performance, returns, expectations and concerns but will go a bit more in-depth on one or two recent investments. There is a danger in writing about investments in that it may create a focus on individual outcomes and not the more important portfolio total return. Also due to human psychology, writing about an idea may make it much harder as an analyst to be detached and make future decisions based on the relevant facts. I am willing to take these risks in order to provide more useful information about New West Investment and the differentiated service delivered to clients.

So far this year large capitalization stocks like those included in the Dow Jones Industrial Average, the Standard & Poor’s 500 and the Russell Top 200 (the index I prefer) have recently been making numerous new, all-time highs, but overall are a mixed bag for the year, with the Dow a bit negative, the S&P a bit positive and the Russell up 1.4%, all including dividends. Smaller company stocks have done somewhat better; because they export fewer goods, they’ve not been negatively impacted by the strong U.S. dollar. Foreign company stock prices have advanced more but the returns are muted by currency headwinds for U.S. investors. U.S. High Yield Bonds (also known as junk, lower-rated, or risky) have advanced in the 2% range for the year.

All U.S. investment grade bond returns are breakeven to negative for the year, including interest earned, based on the duration of the portfolio; longer duration (or time until maturity) equals greater declines. This is the result of interest rates increasing as market participants try to anticipate Federal Reserve Board (Fed) tightening of monetary policy, which at this point is impossible. If at any time in my 30 year career as an investment advisor anyone had said that six plus years into a market and economic recovery with unemployment at 5.3% that interest rates would be at 0%, I would have declared that person daft.

The Fed has set numerous hurdles for the economy to clear prior to increasing interest rates, and then reset them with additional hurdles, leaving rates unchanged at 0%. The stated target is now the likelihood of sustained inflation of 2% or more annually before rates are increased. Of course, current Fed policy is suppressing inflation as measured by the Consumer Price Index (CPI - the validity of which is another issue). Think about oil prices, which have declined substantially due to massive, expensive and not particularly profitable drilling in the U.S. shale formations funded by cheap and available capital fostered by Zero Interest Rate Policy (ZIRP). The production from all those wells has pushed oil supply ahead of demand, forcing prices down.

Easy funding has also saved firms that would have otherwise failed, again increasing the supply of goods available. So while low rates may have stimulated the production of goods it has yet to create measured inflation. Of course, low rates have destroyed demand for goods and services as savers, lacking interest income earnings, have held back on purchases, further suppressing inflation. Therefore, I am not willing to venture a guess as to when, if or how much interest rates increase or decline from here, I am only trying to position portfolios for any possible outcome.

Portfolios managed by New West Investment on average have performed in-line with the large capitalization market indices, up fractionally for the year-to-date. Of course, performance will vary by account based on asset allocation (the amount of funds deployed to stocks, bonds or short-term investments) and security selection, which is impacted by the opportunity set available since portfolios were taken under management.

In the most recent quarter I started purchasing 10-year maturity U.S. Treasury bonds with expected returns in the 2-2½% range. It is not that I am excited by the expected return, although it is higher than what was provided by large capitalization stocks in the decade starting in the year 2000. I am just looking for an asset that returns more than nothing, has no long-term loss potential and could appreciate at a time when the stock market suffers a substantial decline. The risk of a short-term decline in value due to interest rate increases is offset in all accounts by short-term holdings that will mature and can be reinvested at those higher rates. These securities are liquid (can be sold) on a next day basis to provide funds for spending needs or for new investments opportunities that arise.

When selecting company stock to invest in I have a three-step process that I normally use. First I am looking for a high quality business, the measure of which is based on high returns on invested capital compared to other companies. Said another way, I want a company that is abnormally profitable. The second requirement is an attractive entry price compared to the free cash flow the business generates. Free cash flow is defined as funds that are available after all required reinvestments have been made back into the business. Finally, if a company is abnormally profitable, it is going to attract competition, so it must have a sustainable competitive advantage.

Let me illustrate by examining Johnson & Johnson (JNJ), a longer–term holding that I have been recently adding to newer client portfolios. Step 1, JNJ has an amazing return on invested capital, averaging 20% over the last ten years. This means for every dollar invested in the business the return is 20 cents per year after all expenses, interest and taxes. Step 2, as for the price paid per share, JNJ is expected to provide free cash flow per share of $6.55 in 2016, divided by the cash adjusted price of $93 per share equals an expected long-term return of 7%, even with no growth. This looks attractive compared to the limited risk of an investment in the company and the other alternatives. Step 3, JNJ is shielded from competition on multiple levels. The company has patents or brand name recognition that protect key products, finances that are bomb proof as one of very few AAA rated companies in the world, and research and distribution expertise in the top tier of businesses.

Importantly, this has been a consistent business for decades, not a flash in the pan that is liable to flame out. In addition, based on product innovation and a growing and aging global population, sales at JNJ are expected to grow in the future. The likely reason for the attractive current price for new investors is that the stronger dollar versus other currencies (JNJ gets over 50% of sales from overseas) has suppressed earning in the near term. Also the company is not as sexy as some of the newer biotechnology companies hitting new highs even though it is one of the largest biotechs in the world. While there is no guarantee that this will be a successful investment compared to other alternatives, I feel comfortable putting both my own and client's money into the shares of Johnson & Johnson.

Enclosed please find the most recent portfolio report for your review. Feel free to call if you have questions or would like to catch up. And by all means have an enjoyable summer.

Best regards,

Peter V. Hedberg