July 3, 2017

Back in the Fall of 1990, when I was in the process of plotting out my career, one of the driving factors in starting New West Investment versus going to work for a larger money management firm was that I wanted to have client contact. While I enjoy tracking and understanding the economy and geo-political developments, and I love researching industries and companies, doing that work in a vacuum without interaction with the people that would benefit from my work seemed unattractive.

I think that was a great decision and I wanted to take this opportunity to thank every one of you for supporting that vision. Instead of the mindless pursuit of money that occurs in big, industrial finance, together we have sought out the mindful quest of financial independence. While I devote myself to the planning, research and portfolio management that goes into the equation, you have had the confidence and patience to let the process work, and that is huge.

The following text is from an article written by financial blogger Ben Carlson in March of this year that discusses the elements that can provide an investment manager with a sustainable competitive advantage compared to other market participants and sums up some of the founding principles of New West Investment.

> "Here are some barriers to entry that I believe still exist in the markets:
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> **Having a disciplined, faithful client base**. My feeling is that not enough investment firms spend time thinking about or educating their client base. Most are simply willing to take any money that gets thrown their way. When you have a disciplined client base that is willing to see a strategy or plan through that's a huge advantage. Patient capital is hard to find but acts as a huge advantage when others are forced to sell or buy when they don't want to.
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> **Simplifying your approach**. These quant funds aren't spending millions of dollars looking for simple strategies. There's an opportunity for those investors willing to stick with a simple strategy as an offset to those who focus exclusively on complex strategies (many of which don't work).
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> **Having a long time horizon**. I'm convinced that having a long-term mindset and being more patient than other investors is one of the last true edges remaining in the markets. This is one of the few things that can never be arbitraged away by faster computing power or more intelligent hedge funds looking to make a quick buck."

The patient capital part of the discussion is important because the investment markets go through cycles, not just economic or bull and bear market cycles but also growth versus value strategy investment cycles. I lean heavily toward the value approach of investing, meaning I believe that the price one pays for an investment is important, while growth investors care not so much about price. When value is working, like last year, I feel like I am in flow, a state that all is right with the world. Conversely, this year a very few large growth stocks have provided a significant portion of the index returns and it feels like 6 months spent in a dentist chair to me. Thanks for being there with me.

The current market environment reminds me a bit of the late 1990's. People are investing in things that make no economic sense to me at all. Things like Bitcoin and other cryptocurrencies. The prices of these things are going through the roof and everyone is asking about them. These are electronic mediums of exchange that are suggested might be money. But they don't fit the definition of what works well for money. They are backed by cryptocurrency miners and algorithms as opposed to the U.S. or some other government entity.

They can't possibly work well as a store of value or a medium of exchange because the value from moment to moment is so uncertain, swinging 10-15% within hours. Also touted as a benefit is the limited supply, which may be true for Bitcoin, but there are now over 30 such cryptocurrencies and the number is expanding. When I go into a store I can feel confident that they will take cash, check or credit cards, even if not my Discover or American Express. How are cryptocurrencies going to work as money when a

merchant does not take Ethereum or you're not sure if the minute you go to check out you can afford the purchase? And finally they are priced in dollars or other established currencies, validating those existing currencies.

At the same time there are real companies like Nvidia that are skyrocketing because the chipmaker is selling to manufacturers of computers for cryptocurrency miners. This is like Sun Micro Systems' stock exploding upward in 1999 based on sales to the soon to be defunct Pets.com, Webvan.com and other .coms of that era. When these companies failed the sales went away and Sun stock plummeted.

Then there is Tesla, the solar, battery and electric car company. Tesla is valued similarly to Ford and GM in terms of market capitalization even though they produce less than 100,000 cars per year as compared to 2,500,000 and 3,000,000 respectively for the established players. Ford generated revenues of $153 billion (b) and made close to $4 b in profit over the last 12 months, GM $170 b and $10 b, Tesla $9 b and lost almost $1 b. Tesla's business is heavily supported by government subsidies for electric car purchases and I see that the likes of BMW, Mercedes Benz and every other car company are ramping up electric. I get it, Tesla is cool, but we all know the cost of cool.

Finally, Amazon is taking all the air out of the room in retail, and other businesses as well. The company operates two main businesses, Amazon.com and AWS (Amazon Web Services). Although AWS provides less than 10% of total revenue it generates the lion's share of the earnings. Amazon.com basically sells products for 1% over cost, so even if they sell a lot of items they don't make much money. The company trades at 185 times the last years earning, about 10 times the valuation of the companies in the S&P 500. What is interesting is any other company that made basically no money and decided it had expertise in retail, shipping, movie making and now, with the recent purchase of Whole Foods, the brick and mortar grocery business, would have their stock hammered. Amazon was up on the Whole Foods purchase news and other retailers collectively lost over $30 billion in market value that day. Even drug stores and drug distributors got hit.

It is not that I don't think these are real companies, and I buy from Amazon quite often and like the service. For everyday items like groceries I find it much easier to shop in the store as opposed to online. But the real issue is price; why are market participants willing to bid these shares so high as if there are no other stocks to buy? Herd mentally and a limited supply of these concept stocks would be my guess. There have been numerous studies over time that have demonstrated that value investing outperforms growth strategies over the long run. But the long run is made up of a number of short runs like the one we are in now. The key is to take advantage of the lower priced opportunities in the market now and patiently wait for them to play out favorably.

As such, I have been adding to a couple of retailers that I am confident will survive, are not mall dependent and would benefit from the reduction in the number of competitors in the brick and mortar space. I have also been researching and adding to some traditional energy companies. Again, I am being very selective as both industries have challenges that will take some time to work through.

Year to date performance of New West portfolios through June 30th averaged +3.5% before management fees but after all other expenses. We had positive results in all asset classes with bonds advancing about 1.3%, stocks matching the performance of the Russell 2000 and besting value strategies at 5.0% while mutual funds made up of stocks and bonds increased over 8.0%. As I mentioned earlier the popular averages like the Dow Jones, S&P 500 and the NASDAQ indices improved over twice New West's return driven by full exposure to stocks and outsized performance of the big, hot technology stocks like Amazon, Apple, Google parent Alphabet, Netflix, Facebook, none of which I own for clients. If I had owned them in the past I would have sold them by now due to high valuations. Microsoft, which I own in more mature accounts, also went along for the ride.

We have had periods of underperformance like this before. In 1999 New West accounts were breakeven versus a 21.8%+ return for the Russell 200. However over the following three years New West portfolios actually advanced 8.0% during one of the four worst market declines in the last 100 years that had the Russell 200 down 42.5%. The current imbalances in the market are not as great as was the case in 1999

so performance differentials will not be as dramatic, however it always makes sense to avoid red hot sectors and investments and look for quality on sale to preserve capital in a downturn and set a portfolio up for future advances.

As for my conservative asset allocation regarding reduced exposure to stocks I have included two charts to illustrate my reasoning. The first shows house prices compared to rents since 1983. It makes sense that the value of rent generated by a home is a fundamental economic support for prices. Homes prices broke free from rents starting in 2001 through 2006, which led to the housing, and then credit, crisis of 2008-09. When asset prices advance in excess of economic support there is significant risk of capital loss. The second chart shows the S&P 500 index and the underlying company earnings starting in 1988. Again when you see prices outperform earnings by a large amount there is increased risk of capital loss going forward.

In each case there can always be opportunities to buy attractively valued assets in a class even if the broad asset class is overvalued. And the historically low interest rates can support higher valuations in both stocks and real estate. But with the advances we have seen in stock prices and the Federal Reserve Board increasing interest rates, it makes sense to be cautious. In reading through Berkshire Hathaway's 2017 chairman letter to shareholders Warren Buffett notes that he hates to hold cash but is none the less sitting on over $100 billion out of $425 b in assets due to the inability to find attractively priced investments. I should also note that he does not own any of the runaway stocks listed above.

In recognition of the need to cover more research territory rapidly in this current market of fewer attractive opportunities and in the future during the next down phase, whenever that may occur, I recently invested in a robust data resource program that allows me to build databases of the information I use to judge investments. The data updates real time so I can make informed decisions about quantitative aspects of an investment with little effort, leaving more time to focus on qualitative analysis. Having used the tool for a little over a month I am very excited about the potential. It will clearly help in making sure research thought, information and effort does not become obsolete. As I write this I am currently beginning to work my way through the Russell 1000 list of the largest U.S. companies.

In closing, thank you again for partnering with me at New West Investment and enclosed please find your most recent portfolio report. Feel free to contact me regarding any topic and I look forward to seeing you soon.

Best regards,

Peter V. Hedberg