July 5, 2018

Investment results for the second quarter of 2018 returned to the plus column, with each domestic asset class contributing to the effort. For 2018 year-to-date, New West portfolios are breakeven before management fees compared to the Dow Jones Industrial Average -0.73%, Standard & Poor's 500 Index +2.65% and the NASDAQ Composite +9.37%. Which begs the question, "why the divergence?" in performance between these market measures. The simple answer is Amazon, which has a 10% weighting in the NASDAQ, a 3% weighting in the S&P 500 and is not represented in the Dow Jones, or in New West portfolios for that matter.

A year ago I wrote that Amazon was taking all the air out of the room, which still seems to be the case. In fact the five largest stocks in both the NASDAQ and S&P 500 indices are Apple, Amazon, Microsoft, Alphabet (formerly Google) and Facebook, in order of the weighting, or influence on the index performance. This group of five accounts for 46% of the NASDAQ and 15% of the S&P 500 value respectively. Which highlights that buying an S&P 500 or NASDAQ 100 index fund is not a "passive investment" as suggested by many, but is really an outsized bet on the hottest performing big five companies in the index.

This situation is reminiscent of the late 1990's when the focus on a single, high concept and valuation industry drove investment performance, so much so that I went back and re-read the letter I sent to clients dated March 31, 2000. This date turned out to be six days after the S&P 500 peaked on its way to a 46% decline over the next 29 months. New West accounts had breakeven to positive results over roughly the same period. I have excerpted the letter, because it appears that the last half was lost in cyberspace, and have included it unedited.

So if Amazon is winning, why don't I own it in my or client's accounts? The reasons are the same as I discussed in my year ago quarterly letter, the lack of profits generated from every part of the business except Amazon Web Services (AWS) and the price of the stock compared to revenues and earnings of the company. According to a June 30, 2018 article in the Wall Street Journal, AWS represents only 10% of Amazon's revenues but contributes 96% of its operating earnings. That means $180 of $200 billion Amazon revenues generate no earnings, which includes movies, online sales, electronic equipment and advertising. Is it possible that selling everything to everyone, everywhere to be delivered in two days for free is not a good, or at least profitable, business model?

As for the price of the stock compared to revenues, for the 12 months ending March 30, 2018 Amazon's stock price advanced 63% while revenues grew 36%. That is amazing revenue growth for such a large company, but the share price outpaced that. Amazon's sales are valued at 7 times those of Wal-Mart's even as they make no money on 90% of those sales. Sure Amazon sales will likely continue to grow, as they are only half of Wal-Mart's and the lack of profit allows for some merchandise pricing advantage. I wish I had bought the shares at some earlier point, but it makes no sense to me to buy them now.

Instead, last year I purchased shares in other retailers that I believed had staying power, even as their stocks were pounded as Amazon threatened their businesses. These transactions have worked out well as Target gained 38% in the last 14 months; Williams Sonoma is up 31% in 9 months, Advanced Auto plus 58% in 8 months with a 15% advance in Autozone, which was closed out in 6 months. While these returns trail Amazon's stock price increase in the last year, and owning Advance Auto Parts is not near as sexy as Amazon, I am not complaining.

None of these transactions had the risk of buying a low profit company at 3.5 times revenue. Furthermore, I am not bragging or cherry picking by emphasizing the above trades, I had plenty of investments in the last year that went nowhere, gave back prior gains and one large miscalculation, GE. I am trying to provide insight into the thought process I use in making investment decisions on your behalf.

On June 28, 2018 Amazon announced it would purchase online drug retailer PillPack for $1 billion, or 10 times revenue. That same day they rolled out a program to franchise last mile delivery businesses using Amazon branded and financed vehicles. Drug retailing and package delivery businesses have well developed competitors, narrow margins and are mature, similar to the grocery business Amazon expanded into last summer. What has become apparent is Amazon has to enter new businesses of this size to keep up growth or its stock price will likely drop, a lot. They have no choice.

The same day as the announcement, over $17 billion was lopped off the value of drug store and distribution company stocks, as the fear of Amazon entering the business became a reality. The same thing happened a year ago when Amazon announced the purchase of Whole Foods. The grocery giant Kroger's stock declined 26% over two days, a loss that has since been mostly erased. I have been building positions in a couple of drug retailers and distributors over the last few years as the threat of new competition has provided attractive entry prices. Now that rumor has become fact, maybe they can return to a growth path. Amazon's new company has $100 million in annual sales compared to $400 billion for the industry. It is going to take them a while to have a real impact and these established competitors are not standing still waiting to be slaughtered.

I have also been researching the package delivery company stocks for a while and the Amazon news may be just what is needed to get the lower prices I want before investing. UPS and FedEx have moved away from delivering single packages due to the narrow profit margins. Amazon has shifted a lot of this business to the U.S. Postal Service which does not have to generate a profit and in fact losses over $5 billion a year. With the current administration in the White House threatening to address this Amazon subsidy, another plan is needed. So small business franchisees will be asked to run these operations as well as, or better than, UPS, FedEx and USPS or will face losses. I think the big question is where are they going to find drivers given the 3.8% national unemployment rate? Trucking companies are having difficulty finding drivers to the extent that some economists theorize it is holding back domestic economic growth.

I do not take the risk of buying companies that compete with Amazon lightly. Having to compete against a company that is not required by investors to make a profit is a tall order. The Everything Store is amazing, but for a part of my portfolio I am willing to bet profitless prosperity is unsustainable. A number of once great investors have fallen on hard times lately by shorting (betting against) Amazon's stock. I have chosen the course of buying good and profitable companies that will be seen in a better light if/when Amazon falls to earth from its current godly status.

Looking now at the larger landscape of investment markets, the headwinds I referenced in last quarter's letter continue unabated. Interest rates continued to climb to the benefit of New West clients. These increases are the result of: 1 The Federal Reserve Board moving the Fed Funds rate higher, 2 The Fed shrinking their balance sheet by allowing some holdings to mature without reinvesting, 3 Increased inflation which causes some investors to require a higher return to invest and, 4 The dramatic increase in U.S. Government borrowing from roughly $500 billion in 2017 to almost $1 trillion in 2018.

I expected the current stock market disruption being caused by this climb in interest rates to start in 2016, as it did during the first quarter of that year. The Fed had made it clear they intended to lift rates four times that year, and that combined with economic weakness in China lead to a quick 15-30% decline in the various stock indices. That stock market decline scared the Fed governors into reversing course and they held off taking action until the end of the year, leaving me under invested in stocks.

The reason higher interest rates are good for investors and savers can be illustrated reviewing bond investment performance over the last two years. Since June 30, 2016 New West bond investments have been breakeven, however we can now purchase a 2-year U.S. Treasury bond and earn four time more than two years ago, over 2.5% per year for new investments. If The Fed continues to lift rates as they have suggested, we will be able to get positive bond investment returns and be able to reinvest at higher rates still. While 2.5% may seem lukewarm at best, it will feel pretty good when the next recession rolls around. These last two paragraphs provide some insights into why I have been critical of the Fed being slow to start raising interest rates.

Investment markets have also been under pressure from ongoing actions taken by the Executive branch. Oil prices, the stock market and foreign currency market have seen elevated volatility from actions and comments related to dealing with North Korea and Iran, immigration issues and most importantly tariffs placed and threatened on trading partners. There has also been increased commentary from market pundits regarding a leveling out of corporate earnings and the increase of Corporate and Government debt to record levels as compared to economic output.

None of the above headwinds is a reason to sell or reduce investment holdings, but only to be more attentive to the possible downside risks of investments held or new positions contemplated. During 2018 I have been selling stocks where the underlying companies have elevated debt levels and have made repeated and continuing asset allocation decisions I do not agree with. I have two special situations that I have held onto that might fit the definition just outlined and will monitor those closely.

I recently had the opportunity to review a client's portfolio that started with New West Investment 20 years ago. This account has always been managed with a balance of stocks and bonds, yet it outperformed the S&P 500 index over the 20-year period before management fees. Furthermore the worst calendar year drawdown was a -14% decline in 2008 compared to a -36% drop for the S&P 500 index. Finally, the client has withdrawn 154% of the initial investment over the 20 years, which included management fees, and the account balance is still 10% above the starting value. Over the last 20 years the stock market has had two very nasty declines in the 2000-02 period and the 2008-09 time frame. This example brings to mind the tortoise and the hare, while a balanced approach trails when the stock market is making new highs, when full market cycles are included returns and reduced losses validate the strategy.

Finally, in the coming months Charles Schwab will be changing the cash sweep feature for many of New West Investment client accounts. Any idle cash in an investment account will now be placed in a Schwab Bank fund which is FDIC insured up to $250,000. Of course, the return received will be less than is currently the case but I can use U.S. Treasury securities and the Schwab Value Advantage money market fund to maintain safety, liquidity and return at current or better levels. It will just take a greater number of no cost transactions on my part to make this happen. My purpose here is to alert you to and explain the change so the increased activity will not be cause for concern.

Enclosed please find your 2nd quarter 2018 investment portfolio report and invoice. Feel free to contact me with any questions. I hope your summer has been and will continue to be enjoyable.

Best regards,

Peter V. Hedberg