January 6, 2010

Client
Address
City

Dear Client;

It is hard to review the last year without considering the last decade. While the ‘90’s was the decade of promise (full employment, the peace dividend, government surpluses as far as the eye could see) the ‘00’s was the decade of the broken promise (collapsed bubbles in stocks and real estate, ponzi schemes, accounting fraud and bank failures, the return of war and government deficits for eternity). And what appeared to be the miracle cure for economic woes of the earlier decade, easy monetary policy, provided the substance for a severe drug overdose in the most recent. A concern going forward is that the Federal Reserve continues to use that dangerous medicine, more on that later.

In order to avoid the mistakes of the past, it is important to review history. At the beginning of the ‘90’s, Japan ruled the world in the eyes of investors and economists. Since then the Japanese stock market has declined from around 40,000 to around 10,000 and the economy has suffered one rolling recession after another. America at the time, all agreed, had lost its edge. The U.S. stock market went on to provide one of the best returns for a decade ever and the economy had its longest, uninterrupted expansion as well.

The ‘00’s began with America dominating the world economy, with technological and telecommunication innovations providing the fuel. Since then, the stock market has provided a negative return on par with the decade spanning the great depression and the economy has suffered two recessions, the most recent included a credit market meltdown, even with the Federal Reserve cutting short-term interest rates to zero. On the other hand, the emerging economies of the world were seen as hopeless, having just been party to numerous defaults and failures. These markets provided the best investment returns over the last decade and are now placed on a pedestal by economists, especially the BRIC countries; Brazil, Russia, India and China (please see the article titled Contrarian Investor).

The pattern is clear, avoiding today’s market darlings is a good way to dodge long-term investment underperformance, even if it makes one appear somewhat out of touch with the times. A review of the investment performance of the accounts I have managed for the last decade provides the following results. For all investment accounts of at least $50,000 at the beginning and end of the period, the worst total return (gains or losses plus interest and dividends) performance was 3.4% per year, the best was 8.0% per year, with the average being 5.7% per year. There are 15 portfolios in this sample. These results are before management fees but after all other commissions, fees and expenses. That compares to an annualized total return of:

Standard & Poor’s 500	-0.9%	Dow Jones Industrials	1.3%
MSCI Barra EAFE (Developed Int’l)	-1.1%	MSCI Barra BRIC (Emerging Int’l)	11.0%
Russell 2000	3.5%		

It is also important to recognize that New West Investment’s results were achieved with significantly less portfolio value variability as compare to market benchmarks. Why is reducing portfolio volatility important? It has been shown over the last number of years; some of the best mutual fund managers as measured by investment returns have not provided much benefit to their shareholders due to volatile results. Shareholders have jumped into funds after a strong run only to sell out after a weak period. This results in negating the manager’s good work (please see the attached article on the CGM Mutual Fund). Better to find an investment manager you trust with an approach you believe in, and stay the course.

The current economic and market situation concerns me a bit, as the recent recovery in both are the result of extraordinary, unsustainable government intervention (sometimes referred to as the Ponzi economy), the removal of which is likely to cause disruptions. The Federal Reserve has continued with its emergency zero percent interest rate policy (ZIRP), implemented to address the credit market panic even though their recent statements declare that Fed actions quelled the crisis. ZIRP has the effect of infusing exceptional profits into the banking and trading desk community at the expense of savers and longer-term investors. There is nothing natural about ZIRP and the distortions created while it is in place are liable to lead to severe damage to investors when it is removed (please see the attached article regarding Thomas Hoenig).

Also, the significant involvement in the mortgage market by the Fed, as outlined in my last quarterly letter, is scheduled to be withdrawn after the first quarter of 2010. In fact, the most recent, very visible, Federal Reserve Open Market Committee statement provided a grocery list of all of the extraordinary Federal Reserve programs and their sunset dates. Of course, on December 24th, a day to issue a press release that you don't want reviewed and analyzed, the U.S. Treasury removed any restrictions on the amount of aid provided to U.S. Government controlled mortgage companies Fannie Mae and Freddie Mac (please see attached article The Biggest Losers), which will offset the Fed's withdrawal. (This just in, apparently the Federal Reserve policymakers are also concerned about letting the economy stand on its own; please see the attached Some Fed Officials article).

These concerns have led me to a less aggressive portfolio posture than would have been optimal considering the enormous advances in all markets since the lows set during March of 2009. Perfect positioning would have had one invested in the safest companies from a survivability standpoint until March and then throwing caution to the wind and buying those in the greatest peril. In fact, by deciles, the stocks that performed the worst in 2008 performed the best in 2009, and vice versa (please see attached graph). I wish I had been indifferent enough to the safety of your portfolio to switch to all the worst companies in the pit of the market failure, but reasonably I was cautious, and remain so.

Going forward there is little value for new investments in bonds, except for short-term U.S. Treasuries used as a parking place alternative for money market funds yielding 0%. High quality corporate bonds have advanced to such a degree that the yields are unattractive while riskier corporate bonds do not provide enough return to justify the default risk. Municipal issues have also advanced so as not to offer enough return to compensate for the increasing default risk, as state and local governments suffer from reduced tax receipts.

I am still finding singular investments in solid, large capitalization stocks and will use any market corrections to add to those positions. While my concerns about the economy and the markets persist, as long as the Federal Reserve is flooding the markets with money and government entities are engineering real estate market stability, I don't expect much of a sell off.

On a final note, as more of the investment process is affected by government policy and the regulatory burden on the asset management industry is bound to increase, I have added to the personnel at New West Investment Management, Inc. New hire Jordan Hedberg is completing a few classes to finish up his undergraduate degree after spending four years studying history with a business minor at Monmouth College, a small, private liberal arts school in Illinois. As a research and administration assistant, Jordan will be focused on big picture geopolitical issues as well as regulatory, communication, technology and investment research projects.

Enclosed please find your year-end portfolio review, including realized gain loss and 2009 management fee reports. I am mailing these so they will find you while still current. I will be talking to or meeting with you over the coming months to review your investment objectives, cash flow needs and to discuss investment account performance and whatever other topics arise. Please call if you have questions, comments or just want catch up. Have a Happy New Year.

Best regards,

Peter V. Hedberg