January 1, 2014

Dear Client,

Happy New Year! And we enter it with more wealth due to significant appreciation in housing and stock prices during 2013. Home prices increased 13% using the Case Shiller 20 city index, while the S&P 500 had its best year since 1997, up over 30%. All U.S. bonds, with the exception of risky corporate issues (junk bonds), posted negative returns due to an increase in interest rates. New West Investment accounts advanced on average 17% due to the balanced approach we use, with portfolios having higher stock exposure performing better than newer accounts that were not fully invested.

This lack of full investment in some accounts results from stock prices improving at a much faster rate than underlying companies earnings. While stock prices jumped 30% in the year, company earnings are projected to strengthen by only 5%. If we were just coming out of a market decline, this would not be a problem; however, 2013 was the fifth year in a row that the stock market advanced. Furthermore, some measurements of equity valuations look troublesome if one wants to increase stock market exposure.

Before you jump to the conclusion that it is time to sell everything because the stock market is expensive, please consider the following. Stock valuations provide no guidance as to how the market will perform over the next day, week, month, or year. This information is useful only to gauge the risk one is undertaking and to set expectations for potential returns in the longer-run regarding investments. In fact, many have been led astray over the last two decades by focusing on market valuations too intently.

My investing career has mostly overlapped with what I will call the “activist Fed era,” starting with Chairman Alan Greenspan’s drastic actions in response to the stock market crash of 1987. Each economic disruption since has been met with more aggressive decreases in interest rates for longer periods of time. This has developed into Central Bank’s central planning regarding interest rates, which is ironic considering that Greenspan was a libertarian. The activist Fed era has coincided with substantially higher prices for all asset classes relative to the investor’s income stream.

Central planning leads to a misallocation of capital, and the Fed’s version is no exception judging by the number of financial crises over the last 25 years. The problems started with the Savings and Loan crisis in the late 80’s followed by the collapse of Long Term Capital and its threat to the banking system. Soon after was the tech and telecomm bubble and accounting scandals and more recently the real estate bubble and the credit crisis. These higher prices lead to bigger, sharper declines when market forces take over from time to time.

Successful portfolio management still requires matching a client’s financial needs with the individual investment opportunities that are available based on the price paid and the perceived return and risk undertaken. Since mid 2013, I have found few attractive opportunities but not for lack of effort. The result has been a build-up of cash in portfolios. It feels a bit like stepping back from the New Year’s party before the ball drops over concern about the next day’s hangover. But as my experience has grown I feel increasingly comfortable doing just that. Enclosed please find your year-end 2013 portfolio report, and please feel free to contact me if you have questions, concerns, or just want to stay in touch.

Best regards,

Peter V. Hedberg