January 1, 2016

Happy New Year! I hope the turning of the calendar offers exciting and rewarding opportunities for you and your family. That is certainly the case here at New West Investment as I embark on my second quarter century in business. It has been a successful 25 years and I look forward to continuing to work hard to improve the service and the investment results provided.

Going forward I have identified a couple of areas I would like to focus on to improve customer experience. To quote Albert Einstein "Everything should be made as simple as possible, but no simpler." Unfortunately, needless complexity has been added to the financial system over my career to the detriment of many not in the financial services industry. Keeping it simple has always been a goal at New West Investment and I would like to refocus on both the business and investment processes to increase simplicity and transparency. I also recognize that in 25 years I will be 81 years old. Therefore, it is time for me to more seriously consider a plan for business transition so that I can honor and return the trust that has been placed in me by my clients. Neither of these areas will be addressed in a hasty fashion, but please be aware that both are very important to me.

Since founding New West Investment I deeply appreciate the trust clients have placed in me to handle their investments and the faith they have demonstrated in staying the course, evidenced by low client turnover. I have lost more clients to Father Time than to impatience with investment results. Of the clients that I have worked with since 1991, the average annual total return is a bit over 8% (with a range plus or minus 1.0%) before management fees, in line with the Russell 200 stock index return over that period. As important, in only two years were there material portfolio losses compared to four years of double digit declines for the index.

In reviewing investment results for 2015, I am pleased to have added value with much of my portfolio positioning during the year. My expectations for stock returns to be unattractive considering the downside risk led me to keep plenty of investable funds in reserve to stabilize portfolio value, which paid off as the stock market swung between gains and losses, sometimes violently, to finish the year basically unchanged. I did use the market weakness in August and September to add to some holdings at attractive prices. My lack of overseas stock exposure also helped performance as developed markets finished the year a bit negative on average and emerging markets suffered double digit declines due to the strong U.S. dollar, China's economic slowdown and the commodity price collapse.

In 2014 I eliminated all exposure to high yield (junk) bonds and floating rate loans over concern about the declining quality of these investments and increased risk of loss, thus avoiding a rout in the asset class that developed during the fourth quarter of 2015. I used increases in interest rates during the year to increase exposure to U.S. Treasury and municipal bonds, the only fixed income sectors to provide a positive, if marginal, return for the year.

My long-standing aversion to energy master limited partnerships (MLPs) and real estate investment trusts (REITs), past favorites of the income investor set, was finally validated. These investments were exposed as needing constant access to capital markets to continue to pay high dividends. When that access was questioned late last year, many REITs declined in price while MLPs got clobbered.

Sometimes investment performance is defined by what is owned and sometimes by what is not owned, last year New West Investment results were impacted by both. Not withstanding the above mentioned successful portfolio positioning, the wipeout in the energy sector reduced 2015 results, as outlined in my third quarter letter, while the lack of FANG ownership lead to trailing the large stock indices for the year.

What is FANG you ask? It is Wall Street shorthand for Facebook, Amazon, Netflix and Google shares. If you remove these four stocks from the S&P 500 stock index, returns were actually negative for the year. At 106, 965, 303 and 33 times earning, these are not my kind of stocks. But they were must own in order to keep pace with the S&P 500. I am reminded of the end of the 1990's and a couple of must own stocks from that era.

In the summer of 1998, if you did not own Coca Cola (KO) you could not hold your head up as a portfolio manager. From a price of $43.00 per share in June of 1998 the shares now trade at $43.00 per share. No share price advance in over 17 years even though company revenues per share have increased over 2.5 times. Wal-Mart (WMT) was another wonder stock. The price peaked at the end of 1999 at $70.00 per share and now is at $61.00 per share as revenues per share more than quadrupled. Finally Cisco (CSCO) also traded at $70.00 per share in early 2000 and has also quadrupled revenues per share since then, but the stock can now be bought for only $27.00 per share.

These are three great companies that were lousy investments if purchased at must have valuations. Including dividends, Coca-Cola returned less than 2% per year, Wal-Mart less than 1% and Cisco lost almost 4% annually. My experience prevents me from participating in this type of growth investing even if I have to apologize for under performing an index from time to time. So you probably will not be seeing FANG in your portfolio anytime soon.

Keep in mind that if you invest in an S&P 500 index fund, over 5% of your investment will go into FANG company stocks. Adding in Apple (AAPL) and Microsoft (MSFT) will have 11% of your investment in these 6 companies. Maybe avoiding these types of investments is what allowed the New West portfolios managed since the end of 1999 to out perform the Russell 200 index, 6% (with a range plus or minus 1.5%) annually before fees versus 3%.

New West Investment's 2015 portfolio performance results registered a negative 1.6% on average, which landed in the middle of the Russell indices pack. Returns trailed the large stock Russell 200 for the reasons outlined above while besting the Russell Mid Cap and 2000 indices. More mature accounts performed better reflecting more holdings in large capitalization companies while newer portfolios suffered from recently added stocks that weakened, in some cases precipitously. In my career I have never had so many stocks breach the margins of safety identified before purchase. It is a humbling experience, and distressing as my newer clients can only read above about my successful past investment results but have little personal experience of them.

It is important that portfolio performance is at minimum good enough to keep New West clients from wondering if they made a mistake in hiring me and recent results have not convincingly cleared that hurdle. As for experiencing a difficult performance year, New West was in good company with top rated mutual fund manager Donald Yacktman down 5%, while Warren Buffett's Berkshire Hathaway declined 12%, and hedge fund stars David Einhorn and Bill Ackman were hit in the negative 20% range. Investors such as myself that utilize a value approach (they are sensitive to the price paid for an investment) have all faced a headwind recently so we will all be happy to see the calendar flip.

In reviewing the last 25 years and seeing 8% annualized returns I am forced to consider future expected returns. This is not a prediction as forecasting is clearly for fools. Who foresaw 0% interest rates, and more so, lasting for 7 years? That said, we are unlikely to see returns in the 8% range on balanced portfolios going forward as the Federal Funds interest rate started 1991 at over 6% and the 10-year maturity U.S. Treasury bond interest rate exceeded 8% compared to today's approximately 0.25% and 2.25% respectively. It is a tough time to be a balanced account portfolio manager, with only stocks offering the promise of a reasonable return but at an elevated risk to loss of capital. Stocks will also be challenged to advance the 8% annualized total return seen during the last quarter century due to high valuations relative to revenues and earnings, record high profit margins and a very slow growth global economy.

Do not despair, opportunities in the markets routinely present themselves to those that are patient, cautious and have funds available to deploy when prices are more attractive. Bonds are not going to be a great investment based on current interest rates, but I have been placing excess investment funds in Treasuries earning 2%+ due in 5-10 years for safety and to protect against what are likely to be negative interest rates during the next recession. The European Central Bank has already driven interest rates to a negative level in an attempt to stimulate economic growth. The Canadian Central Bank has talked about the likely need for negative rates in the near future to combat the effects of the energy sector implosion while former Federal Reserve Chairmen Ben Bernacke has suggested the U.S. will need to go negative when the economy turns down.

In closing, thank you for being part of the success at New West Investment over the last 25 years and here's to making the next 25 years even better. Enclosed please find your year-end 2015 investment portfolio report. Included are performance, summary, unrealized gain / loss, management fees and realized gain / loss reports (for taxable accounts only). Please use the realized gain / loss report for informational purposes only. Tax accounting for bond investments has become quite complex, so the 1099 provided by Charles Schwab & Company should be relied upon for tax filing requirements. I am available anytime if I can be of assistance.

Best regards,

Peter V. Hedberg