January 3, 2017

Happy New Years! I find that anymore I am happy to start a new year. It is not that I like to see time ticking by; I am aware that I am getting older and closer to the end of life than to the beginning. It is just that if it was a “bad year”, I would like to put it behind me and if it was a “good year” I want to put it in the books before some event or experience has a chance to taint it. It also gives me a single point in time to take stock of the lessons learned and to count my blessings and to let time heal what ails me.

I confine my writings in these periodic letters to things economic, investment and finance related. That does not mean I value those items more highly than other measures of success and happiness, quite the contrary. Financial security is an important part of one’s existence, and the one I am charged with helping improve for my clients, so I take that responsibility very seriously. But money cannot buy happiness, but supports it.

On a financial basis, 2016 was a successful year for New West Investment clients. Using an absolute measure, client accounts were up an estimated average of 8% on the year, with accounts holding more legacy stocks performing a bit weaker and accounts with newer holdings performing a bit better. That return is even more pleasing with the understanding that bond investments, which comprise approximately 45% of holdings, added almost nothing but stability to portfolio performance by year end.

Equity security positions tracked with popular stock indices, while adding to stock holdings during the market weakness at the beginning of the year added to portfolio returns. New West’s worst performing investment for the year knocked only 0.15% off of the year’s return and the other two material decliners only gave back some recent gains and are supported going forward by what I think are improving businesses.

One of the lessons learned during the year was really a reiteration of earlier gained knowledge. The two month decline in the stock market to start last year was likely at least partly due to the Federal Reserve Board members talking tough about raising interest rates, projecting four increases during the year. The market recovered its losses as such talked dissipated. In fact the Fed raised rates only once during the year. Market commentators then predicted a market sell off if the British people voted to exit the European community. They were correct for two days with a 5% decline, which was then reversed in the next two days.

The U.S. presidential election once again provided a canvas on which forecasters and predictors could display their fallibility. A Trump victory was supposed to lead to stock market doom, which was indeed the case for two hours in the middle of election night. The message to be gleaned from all this is that event predictions are unlikely to add value to portfolio management, and may well subtract value. One would need to correctly forecast the event, the policy response and the market’s reaction, a tall order. The factors that matter are being right more often than wrong in aggregate regarding the analysis of economics, risks and valuations of securities selected and balancing that with individual client circumstances.

I’ve read a couple of simple books recently regarding retirement planning, social security distribution strategies and how to think about money. The key takeaways related to financial retirement preparation is to add all income sources together, including distributions from investments, and make sure the annual amount is greater than spending requirements. One should also have a fund for vehicle replacement and major uninsured expenses for items such as vision and dental care. Investments should be managed using a total return approach and distributions should not exceed 4% of the value of the holdings in order to be sustainable. And while the average return on a portfolio is important, it is paramount that big declines in portfolio value be avoided, particularly in the early years.

Understanding the optimum age to claim social security is in most cases equally simple. If one can afford to delay claiming benefits, expected portfolio returns do not comfortably exceed 8% annually and living to be 80 years old is likely, it makes sense to claim benefits when 70. This is even more so the case for a married couple. Of course this is a strategy and since life expectancy and portfolio returns cannot be known in advance, the perfect choice can only be calculated after the fact. Claiming benefits sooner may make sense if life expectancy and expected investment returns change.

The key to understanding how to think about money comes from knowledge of what makes people happy. Numerous studies have made it clear that most people value experiences over possessions in the long run. Enjoyable experiences can be anticipated and create memories that improve over time while many material items lose appeal and become a burden. Also avoiding a “keeping up with the Jones” attitude and mistakes that lead to large capital losses are important to maintaining happiness.

I share the above to inform the factors I consider in dispensing advice and managing investments, particularly my current conservative portfolio positioning based on elevated asset valuations. I would love to discuss these or other topics relating to personal finances in the New Year. I want to increase the interactions I have with clients going forward as it is one of the most enjoyable aspects of my career.

Reviewing investment markets, I would be remiss if I did not touch on interest rate movements during 2016. Rates across the board for U.S. Treasury bonds finished the year a bit higher than where they started. This masks the significant decline that occurred through July, with a strong rebound into year-end. The Federal Reserve Board raised the short-term Fed Funds rate ¼% in December. While the increase in rates presents a head to the performance of our current bond holdings, it creates an opportunity to get higher returns going forward. I have often stated that I thought low interest rates were holding back economic growth during this cycle. As such I am happy to trade a bit of current investment performance for higher potential future returns.

I am still hesitant to broadly increase exposure to the stock market in individual portfolios given the dearth of attractively priced companies and the continued weak earnings growth. I have added and subtracted equity positions opportunistically during the year after more aggressive buying in the January and February market weakness. While downdrafts in stock prices are a problem if fully invested in stocks, they are a blessing for those more conservatively positioned, as it the case with New West portfolios.

The topic of a management fee reduction for clients was touched on in my third quarter letter and I have enclosed a document outlining my thoughts on the matter. There is also a before and after comparison to make the amount of the adjustment clear related to each client. As a reminder, in years past I used to provide a capital gains/loss report at year-end for use in preparing ones taxes. However I discontinued that practice last year after the IRS required brokerage firms such as Charles Schwab to provide that information and the new complexity in calculating gains/losses for bonds increased the chance for a conflict between my report and Charles Schwab. I still include a schedule of management fees paid during the year in the enclosed year-end portfolio report.

I hope you enjoy a happy new year and I look forward to talking with you soon.

Best regards,

Peter V. Hedberg