January 4, 2018

On an absolute basis, 2017 was a successful year for New West Investment clients. Combined accounts advanced over 9% before management fees for the year on a total return basis (interest + dividends + capital gains). Measured by asset class, Cash and equivalents finally increased by a measurable, but tiny, amount at +0.43% for the year. Bonds returned +1.74% in the period, Stocks +15.91% and Mutual funds +18.62%. These results across the board were an improvement from 2016. Of course, since all New West portfolios are managed with particular individual's needs in mind and have different start dates, portfolio asset class weightings and security holdings vary, creating different results for each client.

There are a couple of additional measurements of investment portfolio results that are important; relative and risk adjusted performance. Relative investment results compare how a portfolio performed versus the results of a benchmark, or index, with similar attributes. Risk adjusted results factor in the amount of account value variation that occurs in achieving a given investment result.

When I started New West Investment I set as a goal that the portfolios managed would track, on a total return basis, with the Standard and Poor's 500 stock index. I had this aspiration even as I used a balance of stocks, bonds and cash equivalents in order to reduce portfolio value fluctuation. The effect would be to provide returns similar to fully invested stock portfolios without suffering the same loss of capital in stock market declines, thus outperforming using a risk-adjusted measurement. This goal was predominantly accomplished for clients of New West Investment over stock market and economic cycles until the end of 2015. While account performance would trail the S&P 500 during stock market advances, the reduced loss of capital in downturns allowed for similar returns with much less risk.

I'll never complain about earning a 9% return, especially when my expectations for the year were much lower. That said, I've decided it's prudent to unpack the component parts that generate investment returns to determine if recent relative underperformance is the new normal or just a phase like others I've experienced during my investment career.

The biggest factor in the New West portfolios relative underperformance has been the underweighting in stock holdings compared to the fully invested index. This has always been the case in running balanced portfolios, as bonds and cash trail the results of stock over the long term. Rebalancing a portfolio during stock market corrections and downturns allows for equalization in a tortoise versus hare fashion. However the surprisingly (to me) long period the Federal Reserve has taken to normalize interest rates since the financial crisis has created an extended stock market advance and penalized cash and bond investors with extraordinarily low returns.

The Fed finally got started with the normalization process in late 2015 but has deliberately been very slow in the process. Because I expect the slow pace to continue, I have been looking to opportunistically add to equity holdings. This highlights the second factor impacting New West relative performance; since the 2016 election there has not been a correction of even 3% or a negative return month. This historic run has deprived me of opportunities to broadly increase stock holdings at attractive prices. This has been a more acute problem for newer accounts that have high cash balances.

Finally, the third factor hindering relative performance has been a historically long run of growth stocks, those where the focus is on earnings or revenue growth, providing higher returns than value stocks, where the focus is on the price paid for earning or revenues, the later being the type that New West has used to build a successful track record. A good example is Tesla (TSLA) compared to General Motors (GM). Tesla's share price increased 46% compared to 18% for GM in 2017, while revenues per share are expected to increase 57% versus decline 12% respectively (GM sold off its European operations during the year). Tesla however is expected to lose 80% more per share ($1.5 billion total loss) while GM's earning per share are expected to be about flat year over year ($9.0 billion total profit).

Market participants are willing to pay vast sums for the hopes of future riches while being much less willing to invest in profitable, but currently less favored companies. The ultimate example is the 2017

+1,318% price increase of the crypto currency Bitcoin compared to the more traditional store of value, gold +14%.

While I believe that interest rates will normalize in relation to inflation eventually, we will again have stock and bond markets where prices move down enough to reward balanced and rebalancing investors and that value investing will again be worth pursuing, I am making some adjustments to my investment process. I will moderately increase, as opportunities arise, equity exposure while reserving plenty of funds for client spending needs and to take advantage of any more severe stock market declines.

I will move more rapidly, using mutual funds that mirror my investment beliefs when necessary, to avoid maintaining or building excess cash balances in accounts. And as I alluded to in a recent quarterly letter, I am taking a deeper look into the future potential for companies when considering investments. None of these adjustments means that I am abandoning my founding investing principles, which is the worst reactive and most damaging move an investor can make during extended market advances.

I appreciate working with you to meet your financial needs and look forward to a happy and prosperous new year. Enclosed please find your year-end 2017 portfolio review.

Best regards,

Peter V. Hedberg