October 1, 2014

Dear Client,

The third quarter generated a number of market, economic and geopolitical headlines but little investment return. Results were mixed with some quality bonds advancing while riskier issues declined. The same goes for stocks, with bigger companies having small advances and smaller companies losing a bit. There was a move towards less risky portfolio holdings among market participants.

Market headlines centered on the numerous record highs for the Dow Jones and Standard & Poor's indices even as the Russell 2000 small stock index is down for the year. Also there were multiple mentions of higher interest rates as the Federal Reserve publically contemplates how and when to normalize interest rates even as U.S. Government bond returns were narrowly mixed for the period.

Economically, media focus was on employment improvements, the strong dollar and a solid second quarter showing for U.S. economic output juxtaposed with significantly weakening European and Asian economies. Asia reflects a decline in Japan triggered by a recently imposed sales tax increase combined with slowing growth in China. Struggling Europe was negatively impacted by sanctions imposed on Russia. On the geopolitical front, the second quarter saw continued escalation of the Ukraine versus Russia conflict, expanding Middle East problems focused on the Islamic State, and significant protests in Hong Kong in reaction to China's intent to limit their democratic process.

Normally, this much disruption in the oil producing Mid-East and Russia would have caused a measurable spike in global energy prices. However, global economic weakness, Russian sanctions and new U.S. production trumped geopolitical uncertainty so oil and other commodity prices declined in the period. That provides the perfect segue into a review of a couple of my recent stock selections, which in a word, stunk.

New West Investment successfully uses an investment approach that relies on selecting currently out of favor stocks to minimize risk and maximize return over the longer-term. Over time many of these holdings regain favor when seen in a different market or economic light. A prime example from the last few years is the do nothing performance in Johnson & Johnson and Microsoft shares from mid 2009 through mid 2012 with an over 50% advance in each since then. But I have discovered that in markets like this one, where there are few opportunities to put money to work, that new accounts end up with mostly out of favor stocks and few that are recovering. That is a recipe for bad short-term performance, of which I am aware.

By example, three of my recent selections have declined; Diamond Offshore, Tidewater, Inc. and SkyWest Airlines. Two are in the energy sector and were hit by over capacity, weak oil prices and Russian sanctions while the third is a small stock, a group that is down this year. New clients have these holdings without an offsetting holding in winners such as Microsoft or Home Depot, which have not been purchased recently. All three companies have great recovery potential from the initial purchase price, and much more so from the current lower price. They also have in common that the stock price trades at or well below the book value of the assets used in the business, so could be liquidated at a profit over the longer-term. Having experienced this phenomenon before, I understand these are the challenges facing a value investor but have faith that time will reward the patience required to hold these positions long-term.

Enclosed please find your portfolio review and invoice, if applicable. I hope you had an enjoyable summer. Please contact me with questions, comments or for any assistance I may provide.

Best regards,

Peter V. Hedberg