October 1, 2015

During the third quarter the investment markets finally succumbed to the headwinds that have been building for some time. The total return for the S&P 500 in the period and for the year were negative 6.44% and 5.29%, the Dow Jones Industrials dropped 7.01% and 6.98%, High Yield bonds shed 3.39% for the year while Intermediate-Term U.S Government bonds advanced 5.00% year-to-date. New West Investment accounts also declined in value, but in most cases by a lesser degree due to a more limited exposure to the stock market.

The first of these headwinds is the stronger U.S. dollar and weakening global economies causing Standard & Poors 500 companies expected revenues and earnings in aggregate to decline for the year. Since stocks trade off of expected economic results over the longer-term, these softer expectations have negatively impacted share prices.

Secondly, it has become clear that the China miracle of unending economic growth over 7% annually is unsustainable, something that I have been warning about since 2010. This realization hit hard commodity prices, deflating a bubble created by the Federal Reserve's easy money policy and China's stockpiling of anything extracted from the ground. Companies that make equipment for the extraction industry have also suffered declines in results and share prices.

Finally, the anticipation of the Federal Reserve increasing interest rates, fueled by pronouncements by the Board itself, has created some concern. Normally the stock market continues to advance when the Fed is moving rates higher because corporate results improve with the stronger economy, supporting stock prices. However this time the Fed has waited so long that corporate results are beginning to soften as mentioned above, and the path forward is seen as more risky than normal.

Of course, there are likely many other sub-currents that are adding to the recent market disruption, including turmoil in the Middle East, pre-election politicking, trading system failures and the association of the time of the year with market weakness. On average U.S. stock market declines of 10% happen once a year and since in the U.S. we are not suffering a credit crisis as in 2008 and the economy does not show signs of entering a recession or an inverted yield curve, I am adding in small increments to new and existing equity positions for growth and income.

Instead of writing about a particular investment, I am going to cover in greater detail the oil industry, as it represents, along with other commodity producers, the biggest market story of 2015. It also stands out as a major miscalculation on my part, which is the only way to describe the purchase of stocks that decline 50% or more in value in less than a year from purchase without a similar decline in the broad stock market indices. My investments in this industry were hit by a combination of negative developments that overwhelmed the favorable probabilities of these holdings

While that last statement sounds dramatic, energy holdings have reduced investment performance year-to-date by less than 3% because at New West Investment I manage portfolios with downside risk as my primary concern and diversify by industry group and asset type. And while I have been buying and selling individual energy stocks recently, it is mostly to offset realized gains for the year, and thus tax liability, not reduce exposure to the group. In fact I am looking to add to my exposure in a small way to take advantage of very attractive prices.

I began to increase my energy holdings towards the end of last year based on the individual company's attractive share price relative to free cash flow and discount to book value. In addition, these companies have appealing advantages versus competitors, but in hindsight not enough to make up for the plunge in oil prices. I also theorized that shale oil producers, an area of the industry I have studiously avoided, were not producing a profit based on total costs and there would be a tailing off of supply from that sector, which would support oil prices. Finally, the chaos in the Middle East had reached an elevated level that if it disrupted production or delivery would have a positive impact on the price of oil.

During the first quarter of 2014 global oil supply and demand were roughly in balance at 92 million barrels per day (mb/d). Over the course of the year supply began to outgrow demand until there was a 1 mb/d excess, largely the result of U.S. shale oil production. It turns out that my expectation that this excess would dissipate as shale drilling was reduced was misplaced for the moment. To make matters worse, Saudi Arabia decided to increase daily production by 10%, or 1 mb/d, and the U.S. negotiated to allow Iranian oil back on the market in the near future. The world is now 2 mb/d over-supplied and the result has been an over 50% decline in the price of oil. There is also a market expectation that China's oil use will plateau due to economic weakness.

It is clear I began adding to energy positions too early for the following reasons. First, buying oil stocks when oil prices are not cheap is problematic. This is the fifth time since I started investing in 1984 that oil prices have declined 50% or more. Second, basing share purchases on attractive pricing and company attributes measured from elevated industry revenue and earnings levels was also an issue. Many cyclical industries look cheap after they have experienced an extended run of above average results. For example, housing stocks in 2007 looked cheap right before they crashed because housing sales and earnings were unsustainable.

Last, anticipating that OPEC and Saudi Arabia would manage prices by reducing excess supply was unwise. The Saudis had multiple reasons to punish other producers by driving oil prices lower, which they can easily do because their cost of production is so low. Their goal might be to force high cost oil shale or oil sands producers in North America to cut production, as is beginning to happen, and thus maintain market share. Or, encouraged by the United States, they could be penalizing Russia, which gets 70% of its income from oil exports, for invading Ukraine.

Furthermore, it is possible this is a strategy to undermine alternative energy sources development, such as solar power or electric cars. Considering our overtures towards Iran, maybe the intention is to cut Iran's oil earning power. Most likely, all of the above factor into the Saudi's actions. Whatever the motivation, the maneuver is costing them a huge amount. They were earning $900 million a day at 9 mb/d and are earning $500 million a day at 10 mb/d. That is an annual reduction of $146 billion in revenue to the empire.

So why am I continuing to hold energy stocks? While 2 mb/d excess production seems like a lot, it is only 2% over current demand. Also three of my five companies in the space are trading so cheaply it is as if they may not survive the downturn, which I think is extremely unlikely. I am confident that oil prices below $60 per barrel will more than eliminate the excess supply over my 3 to 5 year investment time horizon while the Middle East mess has only gotten worse and could produce a rapid recovery in oil prices in a moment. For the reasons above, if I did not already own these stocks I would be buying them now.

These investment holdings will likely be solid performers from current levels. North American active drilling rigs have declined almost 60% in the last year, which is decreasing oil production. And as outlined in the Saudi example above, there are many oil producing nations that will find that producing less oil will increase their revenue and decrease their costs. Or as is often said on Wall Street, the cure for low oil prices is low oil prices.

Enclosed please find your investment portfolio performance report covering the periods from inception through September 30, 2015.

Best regards,

Peter V. Hedberg