October 12, 2016,

Often times I start out these quarterly letters with a review of what the investment markets did and how they performed over the last quarter. After reading some new articles published by investment research firm Morningstar on the topic of behavioral economics (a method of economic analysis that applies psychological insights into human behavior to explain economic decision-making) I am reminded that focusing on short-term investment results and market action is the wrong way to approach portfolio review.

There are a number of reasons for this. Many investors have longer-term goals such as having funds available for college expenses, retirement or creating financial independence and looking too short-term can stimulate emotional reactions instead of following established proactive financial plans. In addition, I use an investment approach based on selecting investments with a three to five year time horizon in mind to maximize returns relative to the risk of capital loss. Furthermore, it is most appropriate to measure investment manager performance over a complete market cycle, which includes extended periods of advances and declines. And finally, many day to day, month to month and quarter to quarter price movements are random and not a reflection of the value of underlying assets.

With that in mind I want to report the year-to-date performance for New West Investment portfolios using the perspective of some general financial goals. The aggregate of New West accounts advanced a bit over 6.00% including dividends and interest, net of commissions before taxes and management fees. That would annualize at 8.00% less 0.75% for average fees nets 7.25% for the year. Because many accounts are tax deferred and tax rates vary widely, I am going to ignore taxes in this example, but I always consider tax implications when making investment decisions. The returns of the accounts I manage cluster around the average but can vary widely based on individual investment objectives, circumstances and the opportunity set that has been available since I started handling the account.

Using the rule of 72s, an investment return of 7.2% annually doubles the account value in 10 years. Given the current environment that is a reasonable return for an investor needing capital growth. Looked at from a historic perspective it is also a satisfactory return for a blended account with stocks (the average stock market return in the U.S. over the last 85 years has been 10% annually) and bonds (which might be expected to return 3% a year at best given the current low interest rates), ideal for an investor nearing retirement. The 7.25% annualized return also exceeds the 4% sustainable distribution rate for someone in retirement with an excess to offset inflation. The only place this return comes up short year-to-date is compared to the fully invested and 100% stock market exposed results from the average of the Dow Jones and S&P 500 indices annualized return of 10%. Given individual investment objectives and the current market valuations I do not have any clients that I think this investment positioning would be appropriate for.

The investment results referenced above have been achieved with a stock market exposure of a bit over 50%. This means, that were the stock market to decline 20%, New West accounts would likely drop in value by half that amount. The reason for this allocation is that at this point in the economic and market cycles it is very important that the expected return on an investment be significantly greater than the risk of capital loss. Unfortunately, very few investment ideas today can clear that hurdle. This is the result of stock prices that have climbed while operating earnings have declined since the third quarter of 2014. Many companies are having trouble growing revenues and earnings, while those that are not are excessively priced in my opinion.

Stronger economic growth would help support and lift stock prices in the longer-term. However, as I discussed in a previous letter I believe there are three major headwinds to economic growth in the United States; the low interest earnings of retirees, high student loan debt and muted global economic growth. I am ready to add two more items to that list. After talking to a friend about the cost of health insurance it occurred to me that the increasing burden of healthcare premiums has got to be suppressing spending elsewhere in the economy and may be stifling small business formation and growth.

In addition, the idea of increasing economic growth by lowering interest rates is based on the theory that future demand for goods and services can be pulled forward to today. After almost eight years of low rates it is likely that all the pent-up current and future demand has been satisfied and the result is at best slow economic growth going forward.

Due to the above reasons, as a portfolio manager I have decided that being very careful about making new stock investments, and selling those where returns don't justify the risk, is the proper approach at this time. Of course being cautious is a drag on investment performance and results until the stock market declines in a substantial fashion. At that juncture it preserves capital from loss and allows for the purchase of investments at a more attractive price. A risk aware portfolio management style always looks less attractive to clients the longer and higher the stock market advances. However, when an uptrend reverses to a downtrend the value of portfolio management has a chance to shine.

Enclosed please find your quarterly letter, investment portfolio report and invoice if applicable. I have decided to simplify and lower the management fee structure at New West Investment starting in 2017. Please keep an eye out for a letter during the 4th quarter, which will detail and explain the reasons for the changes.

Best regards,

Peter V. Hedberg