October 5, 2017

Our new home in Broomfield has been working out well. Eli, my grandson, loves the school and the new activities. We enjoy being closer to family and catching up with ~~old~~ long time friends. Our daughter Megan has started back at school and is on her way to a new career. And I have been more available to meet with clients in person without a lot of planning, which has been a benefit as well.

Not much changed in the investment markets during the third quarter. Stock prices continued to track higher, interest rates ticked up a bit, economic growth progressed moderately and inflation as measured by government methods remained subdued. Congressional attempts to repeal the Affordable Healthcare Act persisted while saber rattling endured and the Federal Reserve ever so slowly endeavored to rollback crisis level monetary policies.

New West Investment portfolios increased in value in the period, helped by higher stock prices and interest earned on bond holdings. The historic run of growth stocks outperforming value stocks was a headwind to New West results advancing as rapidly as the market averages, although this trend abated somewhat in September. I have been focused on adding to out of favor stocks and industry sectors, which means carefully considered investments in retail and energy. These holdings were purchased at a recent low point and prices have improved a bit. I have also worked to increase investment portfolio income using stocks and bonds.

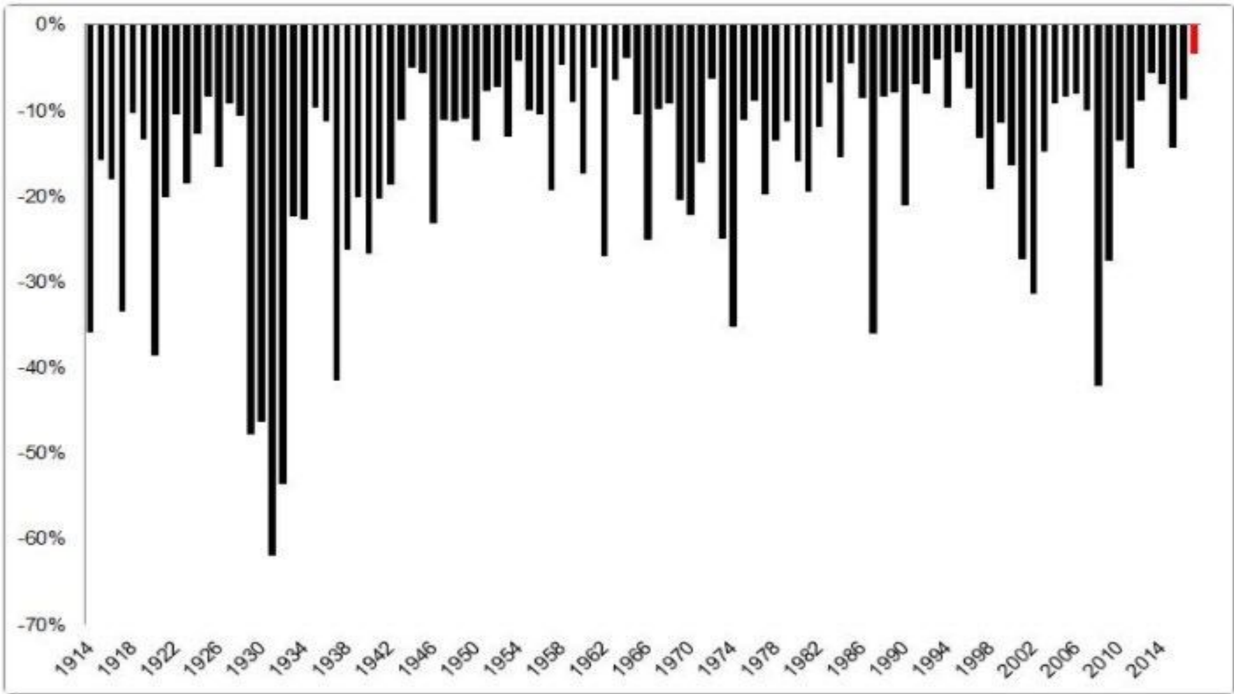
I read more than once recently that being pessimistic and pointing out negatives can often make others perceive a person as more intelligent. And certainly we, and the media, know that negative news sells. The downside is that persistent pessimism can hurt investment results, until there is an economic or market decline. In reviewing prior quarterly letters I noticed I have fallen into a “what to worry about” mind set all too often. Considering that, I decided to take a more balanced approach in reviewing the following recent market and economic items.

Anyone that has been reading my letters knows I think being cognizant of the price paid for an investment is a very important aspect of purchase decisions. When growth stocks outperform value stocks, as is now the case, there are an increased relative number of investors that are of a different opinion. While this hurts the current investment results for value investments held, it provides new investment opportunities that will benefit when these holdings recover as a result of improved operations or perceptions. Although I do own a number of current growth investments in client portfolios, I bought them when they were unloved, at value prices.

It would be an understatement to say that I have been disappointed in how the Federal Reserve Board has handled interest rate policy as the economy recovered. I think it has hurt retired investors by cutting investment income from safe investments while forcing these same investors into higher risk assets at high valuations, which will prove to be a nasty one two punch in the next recession. That said, when I think back eight years, there were valid concerns that the economy and markets would decline into the abyss of another great depression. That has not happened and the markets and economy are in year eight of an expansion, helping drive unemployment to record low levels. While there has been asset price and service cost inflation, there are many items that are purchased regularly at prices that are very reasonable.

I read this morning that the stock market year-to-date has experienced the lowest level of inter-year drawdown (decline) ever, see the graph below. I have often added value for clients by selling expensive stocks and buying other more attractively priced companies when the market declined. This current lack of buying opportunities has made it challenging to put cash to work at reasonable prices. But for people with existing portfolios it has made for a very stress free year so far.

2017 Has Produced the Lowest Maximum Drawdown in the Stock Market in Over 100 Years



Last quarter I touched on the excessive valuation of Tesla. I compared that valuation to the bubble era stocks of the late 1990's. I think that is a fair comparison. I am reminded that for society to make a major technological shift almost requires a bubble. In the mid 1800's the telegraph industry in America boomed and a huge amount of capital flowed into the industry. That capital was deployed to string wires across the country. Too many companies and investors chasing riches led to duplicated and inefficient network construction, causing many of the businesses to fail. The next generation of operators took over the best networks at a fraction of the construction cost and built long-term profitable businesses.

The same thing happened with railroads in the 1890's, autos in the 1920's and the Internet in the 1990's. The excitement of new technology attracts more companies, investors and money than the industry can support, eliminating the possibility of profit and ending in a crash of the companies involved. Eventually from the ashes may arise a few long-term winners taking advantage of decreased competition and inexpensive infrastructure. It can take awhile, but if there is valid technology society and consumers benefit from the wasted capital of investors. Tesla appears to be a one-company bubble that is disrupting the auto industry. Please see the enclosed article I came across this morning.

I have written off the excitement of electric cars and Tesla as way over done. Electric cars are not non-polluting, they just don't pollute at the tail pipe. According to research, driving a Tesla in the Northeast with its coal fired electric plants is no more eco-friendly than an internal combustion vehicle. Electric cars have shorter ranges and there are a limited number of charging stations. Furthermore, who wants to sit around for half an hour while their vehicle recharges? Tesla cars are expensive and electric car purchases are supported by government subsidies that could be removed.

But I am in the process of revisiting that evaluation so I don't make the same mistake with electric cars that I did with the Internet. I judged the Internet as it was in the mid 1990's, not what it became after the flood of wasted capital worked its magic. As a result of Tesla's stock market success, every auto company in the world is investing heavily in research and development related to electric cars and batteries. This will improve the vehicles in terms of range and price.

And now that I am a suburbanite, at least part time, I am reminded that most families have two cars and one could be charged at home and used to commute while the other could be used for longer drives.

Charging at night also makes efficient use of the base electric power grid. There is also a lot of money being invested in alternative energy, which will reduce pollution produced during electric generation. While this shift from all internal combustion to an increase in the percentage of electric may not happen or may take time to occur, I am researching potential winners and losers from the possible shift.

I don't think car companies will benefit. Telsa needs to spend billions to build plants and train workers that the established manufacturers already have and the stock is already priced beyond perfection. Their only hope may lie in licensing their technology to other companies. The existing car companies will be burdened by having to spend money unrelated to the current vehicle platforms. There is already excess auto production capacity in the world.

While I was wondering about the possible negative impacts on oil companies and fuel retailers in a world with a greater percentage of electric vehicles I did some simple math. There are 263 million registered vehicles in the United States and only a bit more than ½ a million are electric, not even ¼ of 1%. Although sales are growing rapidly, in 2016 just 134,000 of the 17.5 million cars sold in this country, or 0.8% were electric. So this technology disruption for non-auto industries is a ways off. The same is likely true for self-driving, or autonomous cars.

On the flip side companies that construct power plants and natural gas producers may benefit in the long run. Please keep in mind this area of research is a new project for me and I am sharing my thoughts so you can understand more about how I am evolving my investment process to improve as the rate of technological change increases. This effort received a jump-start as I was researching my recent investment in General Electric. One of the least loved stocks around, they get 22% of revenues from building and servicing power plants with attractive profit margins. They also have a smaller 7% of revenues that comes from renewable energy, though with not as good margins. I was also attracted by their energy business, which will benefit from a recovery in oil prices. This stock may be seen in a more favorable light in the future, although it is struggling in the moment.

I am also working on learning to what degree demographic changes are affecting businesses and industries as opposed to a normal shift in fashion and tastes combined with over investment in such areas as retail stores, restaurants, media, entertainment, communications and transportation.

I have heard from numerous people about, and experienced myself, the disruption that the new world of communications has had on legacy systems. Moving my work phones to my home office after I sold the building in town was three weeks of stress and aggravation. I figured it was due to Westcliffe's remote location. Well there is nothing remote about suburban Broomfield and I still had to wait two weeks to get a phone installed, and it never happened. I had to switch to getting internet access from the cable company. The reason I tell you this is I am going to drop my fax line and it may wreak havoc (call if you need to fax me something).

When I am in Westcliffe, I use my office number 719 783-4445 and you can leave a message if I don't answer. When I am in Broomfield, that number is forwarded to my cell 719 250-4883. If you ever get a "this number has been disconnected" message please use another number, email, text or message me. Also, voice mails on my cell are slow to show up in Westcliffe, so please try to reach me again if there has been a delay in my getting back to you. I am sorry about any inconvenience, but as some things get better, others are getting worse.

Enclose please find your most recent portfolio report and invoice. I look forward to having the opportunity to catch up when we next speak. Please contact me if I can help in any way.

Best regards,

Peter V. Hedberg

The Trillion Dollar Market That Stopped Chasing Profits

By Irina Slav - Oct 04, 2017, 6:00 PM CDT for Oilprice.com

Every carmaker worth their salt is developing electric cars. It's like a virus that's going around infecting car-manufacturing companies. The virus' name, of course, is Tesla—with observers seeing Elon Musk's "marketing mastery" as the driving force behind the EV craze.

Tesla's popularity seems to defy logic, or at least the logic that says profit is the ultimate goal of any business, and it should come in big and fast. But Tesla lounges comfortably in the red. Other carmakers are losing money on their electric vehicles as well. Yet both Tesla and the others continue to make them. Why, the profit-focused minds wonder?

Environmental regulation is the most obvious answer. Several European countries, some U.S. states, and more importantly, India and China, have all passed regulations that would support the growth of electric car demand in the years to come. India plans to go all electric car by 2030. China has given itself until 2040 to phase out internal combustion engines in passenger cars.

With China already the biggest car market in the world and India close behind, it's not surprising that carmakers are in a rush to offer these markets a choice of electric vehicles, even if it's not profitable today.

Even Big Oil is joining the EV rush: Shell is developing smart EV charging stations, wary of forecasts such as Goldman Sachs' recent one that oil demand could peak by 2024. It may be too oil-pessimistic but it's not out of the question.

But, those skeptic observers say, EVs are still rather expensive. Plus, people like their gas-guzzlers. Indeed, lithium-ion batteries are still on the costly side, with 1 kWh costing GM $145 to produce. Chances are 1 kWh of battery time isn't much cheaper for other EV makers, either. Yet a lot of work is going into lowering battery costs, so they're bound to come down in a significant way sooner or later.

Bloomberg New Energy Finance says battery costs will decline to $109 by 2025 and to $73 by 2030. The Department of Energy forecasts the $100 mark will be reached in 2022; GM and Tesla forecast the same. That's just five years from now, which is probably making oil majors devise contingency plans. Or not, because bar Tesla, carmakers are still making money on regular cars and bleeding cash on EVs.

The numbers are quite impressive: Fiat Chrysler is losing $20,000 on its electric Fiat 500 version—per car. GM loses $9,000 on every Chevrolet Bolt. And yet the latter has announced one of the most ambitious EV plans for the medium term.

Tesla doesn't have ICE cars to offset losses on its flagship but it's making cars and selling them: 450,000 people have pre-ordered the Model 3. And the company's stock has been remarkably resilient. Not only has it risen despite negative bottom-line figures, but this week the shares dropped on reports of lower than expected Model 3 production numbers, and recovered within a day.

The logic of enduring years of loss making in efforts to secure a substantial share of a nascent market might be alien for traditional business, but that doesn't make it unreasonable. Regardless of how much drivers love their SUVs and pickup trucks and regardless how much they get annoyed with longer charging times for EV as compared with ICE vehicle fueling, there's a mental shift happening on a global level, and it will only spread.

It could take five years or it could take 10, but when it comes to EV sales forecasts, there is consensus: these will only grow from here on out. With costs falling consistently and with the help of government incentives, EVs will start making profits in the not too distant future.

In case anyone has an ironic comment about EV tax incentives, remember that it’s not the only industry benefiting from pointed government support. Oil and gas in the U.S. and UK, to mention merely two, also enjoys subsidies in various forms. In other words, governments are supporting two opposing ca