April 3, 2014

Dear Client,

Both stock and bond investments, and portfolios managed by New West Investment, produced small gains during the first quarter despite numerous headwinds. Stocks fought off high valuations, speculative excesses, economic slowdowns in China and emerging markets, disruptions caused by severe weather in the U.S., and geo-political issues in Ukraine. While both stock and bond investors had to contemplate the possible effects of a reduction in bond purchases by the Federal Reserve, known as “the taper.” The advances likely are the result of a lack of good investment alternatives as the Fed continued its zero interest rate policy, or “ZIRP.”

On February 3rd Janet Yellen was sworn in as the first female chairperson of the Federal Reserve Board, replacing Ben Bernanke. A long-time board member, Ms. Yellen continued the policies of her predecessor but with her own flair. The former Berkeley professor has an academic record of focusing on the human impact of unemployment. This was on display during a speech she gave on March 31st when she cited three personal examples of under-employed individuals to support the current monetary policies of keeping interest rates low for an extended period of time. These personal narratives to justify monetary policy were a first. It was later revealed that two of the subjects had criminal records.

The problem, as I see it, is by focusing only on the unemployment rate, and keeping interest rates at an un-naturally low level, the Fed risks creating, or has created, enormous distortion in a market economy. The Fed is actively promoting price inflation in goods, services, and assets with the belief that this will generate jobs. Embedded is an assumption that the economy would not generate jobs were it not for Fed intervention while causing individuals to pay inflated prices and depriving them of adequate returns on their savings. This is bad policy in my opinion. I have no issue with Fed intervention during an economic crisis, but over five years into an economic and market recovery and with stock prices at record highs, these interventions need to be removed.

So why do I keep harping about ZIRP? Because New West is hired by clients to be a good shopper for investment assets with which to build a portfolio. That means getting good value, whether income or growth potential, for the price paid for an investment. Asset price inflation increases the risk that my clients will suffer either reduced returns by avoiding overpriced investments or the loss of principal when the inflation dissipates, or maybe both. This storyline from today’s Wall Street Journal highlights the issue: “Investors are snapping up low-rated securities backed by companies, home mortgages and car loans at a clip rarely seen since the financial crisis, as fund managers and others tire of paltry yields on safer assets.” Isn’t this mindless pursuit of return what caused the 2008 financial crisis? I think so.

Also speaking for the record, some individuals with outstanding histories of avoiding market pitfalls over the last 15 years are warning about high asset prices: 2013 Nobel Economics prize winner Robert J. Shiller of Yale, Jeremy Grantham of global asset management firm GMO, and hedge fund manager extraordinaire Seth Klarman. I hope this explains why I have been so careful in deploying investment capital for my clients recently. Feel free to contact me with questions, comments, or observations.

Enclosed please find the first quarter report for your investment portfolio, along with the Material Change page from our annual Form ADV Part 2A amendment (if you would like a copy of the complete Form ADV Part 2, A & B, please contact our office).

Best regards,

Peter V. Hedberg