Cheviot Value Management, LLC

Investment Values

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"You never know the value of liquidity until you need it and don't have access to it. Crises remind you that you have to set up a rainy day reserve account." – Robert Rodriguez

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CURRENT OUTLOOK

The economy

Although we are optimistic about the long-term economic future of America, we expect the economy to remain sluggish for some time. Consumer spending (two-thirds of economic activity) will linger below past levels as an aggregate of 16% or more of employment-age Americans are out of work, working part time, or too discouraged even to look for work.

House prices are still falling in most of the country, with many foreclosures yet to come, and over one in four homeowners has negative equity in their home. On the bright side, nearly 40 percent of all home-owning households have no mortgage debt of any kind.

Business loans are hard to come by as banks, having been burned by their recent reckless lending practices, are now rededicated to the maxim enunciated by Ogden Nash that "a banker must never lend any money to anybody unless they don't need it."

Real estate

On March 29, 2011 federal regulators adopted a policy of requiring a 20% down payment before mortgage loan originators can package such loans for sale to investors without keeping some of the risk on their books. If such a policy had been applied to *all* lenders starting ten years ago, it is virtually certain the housing bubble would not have expanded to a dangerous size and, therefore, we would have avoided much of the mortgage meltdown and related financial crisis.

Unfortunately, the new proposal will not apply to Fannie Mae, Freddie Mac and FHA even though they account for about 90% of current mortgage originations.

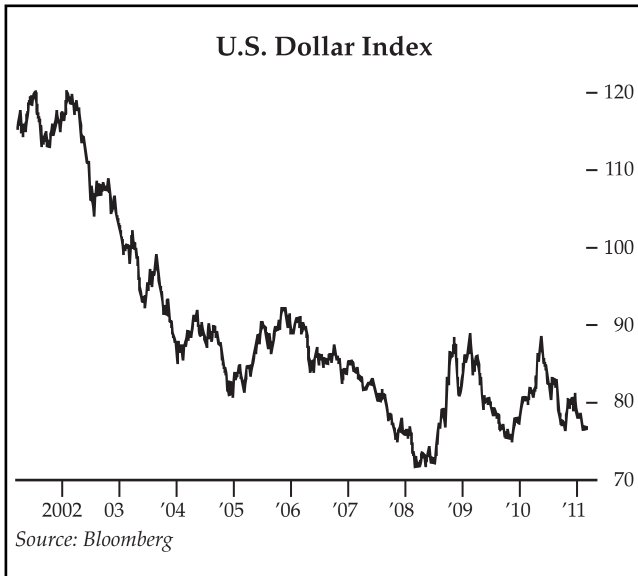
Inflation

According to the widely followed federal Consumer Price Index (CPI), there was no inflation last year and inflation of only 2.3% on average per year over the decade of the 2000's. However, the CPI probably under-states the rising prices most Americans pay for important expenses. Over the past ten years prices rose an average of nearly 7% a year for homeowners insurance, property taxes, electricity, gasoline and heating oil, Medicare premiums, potatoes, bread, and eggs. Price inflation seems to be ubiquitous now.

The dollar and precious metals

Rising dollar prices for goods and services are testimony to the continuing debasement of the

purchasing power of the dollar. The dollar has fallen by nearly a third against other world currencies over the past ten years, as illustrated in the accompanying graph, which measures the purchasing power of the dollar against a group of currencies including the Euro, Japanese Yen, British pound, Canadian dollar, Swiss franc and Swedish krona.



Because we foresee more inflation and the potential for lots of it, our commitment to precious metals securities is intended to provide a hedge against loss of purchasing power of the dollar. These securities provide a way to hold gold and silver indirectly through the mechanism of the stock market.

Today's Fed promises to prevent high inflation even while pursuing policies like those of the 1970s which then caused high inflation, bringing to mind Albert Einstein's observation that insanity is doing the same thing over and over again and expecting different results.

Gold is up over 400% from its low of 2000. That does not mean it won't go far higher. According to Felix Zulauf, an internationally respected expert on monetary matters, "…structural trends are in place for a continued rise of public-sector debt in the industrialized countries, a continued monetization of debt and continued debasement of currencies, all of which are bullish long-term for gold."[1]

A leading expert on the Fed says that sustained inflation always follows large increases in money-supply growth coupled with negative real interest rates, which is what we have now.[2] What the Fed is doing other central banks are also doing, creating rising global demand for gold.

Cash, stocks and bonds

In explaining why Berkshire Hathaway had 24% of marketable investments in cash at December 31, 2010 CEO Warren Buffett said in the company's annual report that safety of cash was paramount because "more money has been lost reaching for yield than at the point of a gun."

The Fed has created $2 trillion in new money the past two years, intending to cause banks to make more consumer and business loans. However, banks are holding their cash rather than doing much lending. Due to near-zero interest rates on cash equivalents, low interest rates on safe bonds, and concerns about municipal bond creditworthiness, and with real estate in the doldrums, the stock market and commodities have become the default option for large sums of money in the hands of institutional investors.

A ten-year Treasury note with a 3½% annual interest payment is a potential money loser if interest rates and inflation increase to an average of more than 3½% over the next decade, as inflation would negate the interest, and the principal repayment would lose 30% or more of its purchasing power by the maturity date.

For value investors, such as our firm, the stock market decline of 2008-2009 did little more than return the market, as represented by the S&P 500, to fair value at the bottom of the decline. The doubling of the S&P in the past two years has taken it again to an over-valued level, as shown in the graph on page 4 below. However, we continue to see reasonable value in the shares of large, well-entrenched companies that are selling at a considerable discount to the overall market. Many such companies earn significant income overseas, which affords them and their shareholders with some protection against a decline of the dollar against other leading currencies.

Reasons for long-term optimism

As Warren Buffett said recently, there is an abundance of opportunity in America; human potential is far from exhausted and the American system for unleashing that potential remains alive and effective.[3] American innovation comes from our rich and unique culture of individual liberty, limits on government interference with the activities of individuals, social mobility, immigrant assimilation, intellectual freedom, property rights and the rule of law. According to renowned historian Paul Johnson, "America has such huge strengths – particularly its freedom of thought and expression – that it's going to survive as a top nation for the foreseeable future."[4]

Historian Victor Davis Hanson agrees, saying that "unlike Russia, China, Egypt, or Greece, [America] is stable, transparent, tolerant, and free of civil strife. Almost all of its apparently healthy rivals in fact are not. America integrates immigrants and assimilates races and ethnicities in a way Europe, Russia, China and Japan cannot."[5]

The head of the Government of Singapore Investment Corp., one of the world's most active sovereign-wealth funds, says that Americans are too negative about their own country, which he views as "one of the most innovative, open economies in the world."[6]

We are not doomed to experience repeated cycles of boom and bust. Even the Federal Reserve, which is the source of much of our current economic distress, can change course. The Fed has the power to stop just about any macro trend in the financial markets if it makes up its collective mind to do so, as it did under the leadership of Fed Chairman Paul Volcker, when the Fed tamed high inflation in 1979-1982.

There are solutions to the major debt and deficit problems of America's federal, state and local governments. Individuals, families, companies and countries cope with problems. At the personal level, many Americans are coping with the economic downturn by reducing spending and debt and increasing saving for the future. That is how America could also cope with its seemingly intractable rise of government debt and deficits.

In a positive sign that our federal government may begin to cope with its financial problems, sixty-four U.S. senators, half Democrats and half Republicans, recently sent a letter to the President saying "we believe comprehensive deficit reduction measures are imperative."[7] These words may turn into constructive action as they reflect deep concern of the legislators' constituents.

BOOK REVIEW

Wall Street Revalued: Imperfect Markets and Inept Central Bankers (Wiley 2009) by Andrew Smithers, 246 pages.

Since the eruption of financial crisis in 2008, a spate of books has appeared seeking to explain the cause, and identify the culprits of the financial crisis. Andrew Smithers' *Wall Street Revalued* is one of the very best of these books.

In the late 1980s Smithers declared that Japan was in the biggest equity and real estate double bubble of all time, described how it would unfold and predicted correctly that it would be the longest running bear event in history. In early 2000 Smithers and co-author Stephen Wright published *Valuing Wall Street: Protecting Wealth in Turbulent Markets* which said that the U.S. stock market was dangerously over-priced and predicted correctly that the U.S. stock market was certain to fall a long way and commented that economic recessions have always accompanied such major stock market declines.

In *Wall Street Revalued* Smithers contends that over the past 20 years flawed policies of the Federal Reserve, intended to minimize stock market declines and economic recessions, instead have been a fundamental cause of our current financial troubles.

The main theses of the book are:

1. The Fed should be concerned about excessive prices in the stock market and the housing market and should take action to restrain the formation of asset price bubbles in these markets because of their extremely negative impact on the overall economy.
2. The market for shares fluctuates around fair value, usually neither too far above or below fair value to cause concern, but sometimes reaching

levels dangerously above fair value. House prices fluctuate around their affordability.

3. High precision about the extent of overvaluation is not essential for the purpose of forming a reasonable judgment as to whether stock market prices are moving into dangerous territory. On the basis of two measures of stock market valuation (described below) it is relatively easy to form such a judgment. In the past, whenever asset prices have reached a dangerously high level there was a subsequent market fall accompanied or followed shortly by economic recession.

Smithers writes: "While the invention of new and complex financial instruments, and the incentive to managements' folly given by their absurd bonuses and remuneration may have added zest to the flames, the fuel on which the fire relied was the excessive liquidity provided by central banks and the asymmetric management of interest rates [by the Fed which] had, justifiably. . . given the impression that it would reduce interest rates in response to falls in asset prices while remaining indifferent to any rises."

The fundamental error of the Fed was its reliance on the "Efficient Market Hypothesis" (EMH) which posits that market prices incorporate all available information on value, and therefore no one could identify a bubble in asset prices as it was forming, and the best that could be done was to clean up the aftermath of a collapsed bubble. Although the EMH has been falsified for a long time, its adherents in academia, Wall Street, and government continue to treat it as orthodoxy.

Smithers finds that there are two reliable measures of fair value in the stock market:

1. ***q***, which is the ratio of the aggregate stock market value of non-financial U.S. corporations to the aggregate net worth of the companies; and
2. The cyclically adjusted price/earnings ratio (CAPE).

In the ***q*** ratio, corporate net worth is the replacement value of the tangible assets of non-financial corporations. In his first book Smithers said that at the end of 1998 the stock market was outrageously over-priced in terms of ***q***.[8] The stock market validated his opinion with its negative total return over the ensuing ten years, 1999-2008.

As illustrated in the accompanying graph, in *Wall Street Revalued,* issued in 2009, Smithers said that as of the end of 2008, when the S&P was at 903, the U.S. stock market was over-priced by 30.6% in terms of ***q***.

Q Ratio Since 1950

Source: dshort.com

Smithers' other reliable measure of stock market value is the cyclically adjusted price/earnings ratio (CAPE) which is the ratio of a stock market index such as the S&P 500 to the inflation-adjusted average earnings of the companies in the index over the preceding ten years. Smithers finds that CAPE confirms ***q*** and that using either measure the stock market was dangerously over-priced at the end of 2008. Having gone up 40% since then the market is now still more over-priced according to a recent statement by Smithers.[9]

Over the past 20 years the Fed time and again stimulated the economy to avoid recession. However, this has led to an economic downturn that appears far worse than the Fed expected.

Smithers contends that the Fed's continually stimulative monetary policy was the most signifi-

cant contributor to the double bubble in shares and houses. Smithers wrote this book to argue that the Fed should have taken action to restrain the bubbles forming in shares and houses.

"The price of liquidity" is another measure of financial danger cited by Smithers. The price of liquidity measures the difference between the interest rate on the most risk-free, short-term debt obligations (such as U.S. Treasury debt) and the likely future returns from the stock market and house prices.

The price of liquidity is high when shares and houses are so cheaply priced that prospective returns from cash equivalents are relatively low compared to prospective returns from shares and houses. *I.e*, one gives up a lot of future return by holding too much cash in an under-valued market for shares and houses. Conversely, the price of liquidity is low when share and home prices are higher than fair value, so that investors are likely to be better off with large cash positions.

The Fed believed in the EMH – that markets cannot be valued. Therefore, they believed it is impossible to know if markets are over-valued and futile to attempt to prevent them from going to over-valued. Accordingly, Fed policy was to wait until a bubble deflates then clean up the aftermath.

During the latter part of the 1990s the Fed failed to recognize the formation of a huge stock market bubble which collapsed in the stock market crash of 2000-2002 and the accompanying recession of 2001. From 2001 through mid-2004 the policy of the Fed was to stimulate the economy by extremely low interest rates. In Smithers' analysis, the market response to "these follies of the Fed," was large increases in the prices of shares and houses and a large fall in the return to investors for holding the most liquid assets such as cash equivalents.

The author writes, "[h]ad the [Fed] adjusted its policy and succeeded in avoiding the excesses of the 2000 stock market bubble, the subsequent bubbles in house prices and many financial assets would probably not have happened…If the Federal Reserve …had been concerned with asset prices, as this book argues [it] should, then [it] had plenty of evidence that house prices had risen to dangerous levels."

Smithers also argues that the debt level of US corporations is at a record high level[10] and, therefore, another "major threat to the US economy…is that bank lending to nonfinancial corporations will, in retrospect, appear to have been as ill-considered as mortgage lending."

The author's view is that central banks can know if the prices of shares, homes, and risky debt assets have reached excessive levels and in such case should take action to reverse bubbles in asset prices. He opines that "[e]ven if it is accepted that a recession would have resulted, it is reasonable to think that mild recessions are preferable to the costs of avoiding them if that cost is, as subsequent events suggest, very high in terms of subsequent large losses in output, financial turmoil and large increases in fiscal deficits and government debt levels."

Smithers concludes that *"We can…measure the extent to which financial asset prices move away from fair value. The claim that this is not possible is without merit and has been a major cause of central banks' failure to address the problems that come from exorbitant asset prices…*

"[T]here is no long-term relationship between interest rates and asset prices. If the latter rise too much they will fall independently of changes in interest rates and, as a result, monetary policy in its usual form ceases to be effective. We are currently suffering from this [as shown by the Fed's extreme monetary stimulus measures of 2009 to date, which have failed to reinvigorate the economy]."

SOCIAL SECURITY BENEFIT ELECTIONS

Choosing when to begin taking Social Security benefits can be a daunting task.[11] There are three basic options for taking Social Security benefits: begin taking benefits early (age 62 to age 66); begin taking full retirement benefits at age 66; delay taking benefits up until age 70. Benefits are permanently reduced by as much as 25% for starting before age 66. Delayed benefits are increased by 8% (plus an inflation adjustment) for each year past age 66. The maximum benefit, at age 70, is 132% of the full retirement age payout.

To make the best decision, one must consider health, income before retirement, income during retirement, and taxes. There are several arguments for taking benefits as soon as they are available:

1. Since we do not know when we will die, we should take advantage of early inception of benefit payments in order not to be cheated by a premature death.
2. Even if one lives to a normal life expectancy, it would take up to twelve years for higher benefits starting at age 66 to make up for the four years of lower benefits available by starting at age 62.
3. Benefits are increased each year by an amount equal to the increase in the Consumer Price Index (CPI). However, since the late 1970s, a number of changes made in the methodology of determining the CPI have caused (1) significant understatement of the rate of increase in the CPI and (2) a consequent significant reduction in the real value of Social Security benefits.[12] Therefore, it is likely that future cost of living adjustments for Social Security, based on the CPI, will not keep up with the true increase in the cost of living.
4. Social Security has enormous unfunded future liabilities that will likely cause Congress to change the law to reduce the cost and value of future Social Security benefits.[13]

A potentially shorter life expectancy due to health status is cause to take benefits as soon as possible. Since men as a group have a shorter life expectancy than women, a single man has more financial cause to start benefits early.

The estimation of future benefits is affected by marital status. A divorced spouse who was married for ten years or longer can receive Social Security spousal benefits based on the record of his or her former spouse.

Social Security provides spousal benefits. *E.g.*, a wife's spousal benefit could be as much as 50% of her husband's benefit, and that could be more than her own earned benefit. The wife's spousal benefit is not available until the husband starts taking his earned benefit.

Married people should take into account their joint life expectancy and the earned benefits each may have under the system before either one files for benefits. For example, the wife's spousal benefits under her husband's Social Security may be higher than her own accrued Social Security benefit. In such case it might be best for the wife to postpone taking her own benefit at least until it equals her spousal benefit.

A spousal benefit taken before full benefit age will be reduced for every month under full benefit age. Suppose a husband's benefit is $2,000 at full retirement age. If his wife also waits until her full retirement age to start her spousal benefit, she will draw 50%, or $1,000, for a combined $3,000 monthly benefit. However, if the husband starts his benefit at age 62, it will be reduced by 25% to $1,500. If the wife starts drawing a spousal benefit at age 62, she will not even receive 50% of the husband's $1,500 monthly amount; her benefit will be reduced by 25% from $750 to $562.50 for a combined benefit of $2,062.50.

Social Security also provides surviving spouse benefits equal to the benefit of the deceased spouse. A surviving spouse of a retiree drawing Social Security will receive 100% of that benefit, providing he or she is at full retirement age. If a husband's earliest retirement benefit is $500 per month lower than at full retirement and he chooses the earliest

Total return for one year; returns for periods greater than one year are annualized; all returns include dividends and interest; all Composite returns are net of commissions and advisory fees. Periods ended 3/31/11.

	1-year	3-year	5-year	10-year
CVM Balanced Portfolio Composite	11.38%	5.15%	5.93%	5.40%
S&P 500 Index	15.29%	2.26%	2.54%	3.25%

retirement date, the survivor's benefit will also be $500 per month lower.

Married couples should also consider taking advantage of a voluntary suspension option, in which, *e.g.,* a husband files for his benefit at full retirement age, and the wife files for the spousal benefit. The husband may request a voluntary suspension of his benefit. If the wife is at full retirement age she would be entitled to collect her full spousal benefit while the husband's future benefit will grow by 8% annually.

Married persons can take advantage of another strategy if both qualify for benefits based on their own work record. Thus, a husband could delay starting his own benefit until age 70, in the meantime starting a spousal benefit as early as age 66 based on his wife's earnings record. At age 70 (or earlier if he chose) he could switch to his own higher benefit. In this scenario, upon the husband's death the wife might receive a survivor's benefit higher than her own benefit. The higher earner cannot use this tactic if he or she is younger than full retirement age.

This variety of choices indicates that for many it may be wise to seek professional advice when making decisions about benefit elections.

CREDITS

Frederic G. Marks, Darren C. Pollock, and David A. Horvitz contributed to the research and writing of the articles in this issue of *Investment Values.* Typographic design, formatting and printing are by Media Graphics of Hawthorne, California.

COMPOSITE PORTFOLIO

In 1997 we established our Balanced Portfolio Composite (the "Composite") using client data beginning January 1, 1992. The Composite includes all fully discretionary, fee-paying accounts over $250,000.00. The Composite assets are allocated principally among the following asset classes: equities (common stocks), fixed income (bonds) and cash. Cash is allocated in accordance with the views of our firm's investment officers regarding the relative desirability of being more or less fully invested in other asset classes from time to time.

In the Composite, client accounts are combined for performance reporting purposes to provide a "Composite" return. The Composite represents real money invested for clients.

In the three months ended March 31, 2011 we eliminated our position in **Verizon Communications,** increased our positions in **Microsoft** and **Newmont Mining** and reduced our position in **Pfizer**. The table below sets forth the holdings in our Composite as of March 31, 2011.

Composite Portfolio Holdings as of March 31, 2011

Security	Pct. Assets
Market Vectors Gold Miners ETF	8.9
Newmont Mining	8.0
Berkshire Hathaway	6.9
Federated Prudent Dollar Bear Fund	6.3
Central Fund of Canada	5.1
Federated Prudent Bear Fund	4.5
Pfizer	4.2
Pan American Silver	3.9
Leucadia National	3.3
Johnson & Johnson	2.7
Medtronic	2.4
Microsoft	2.4
Abbott Laboratories	2.1
Wal-Mart Stores	2.0
Stryker	2.0
Eli Lilly	1.6
Bristol Myers-Squibb	1.4
ConocoPhillips	1.3
Markel	1.1
CVS/Caremark	1.0
Chevron	1.0
Berkshire Hathaway, 7.125% due 10/15/2023	0.9
Other	3.5
Cash Equivalents	23.5
Total	100.0

COMPOSITE PERFORMANCE INFORMATION

The performance results displayed herein represent the investment performance record for the Balanced Portfolio Composite, a Composite of balanced accounts managed by Cheviot Value Management, LLC, a registered investment adviser under the Investment Advisers Act of 1940.

The Composite returns are total, time weighted returns expressed in U.S. dollars and include the reinvestment of dividends and other earnings and the deduction of transaction charges and investment advisory fees of 1% per annum.

The S&P 500 Index is a market capitalization weighted index of 500 of the largest U.S. companies. The returns for the S&P 500 Index are calculated on a total return basis with dividends reinvested. The S&P 500 Index is not available for direct investment.

Past performance is no guarantee of future results. Any investment in marketable securities has the possibility of both gain and loss. Results will vary among client accounts. The actual return and value of an account will fluctuate and at any point in time could be worth more or less than the initial amount invested.

Holdings are subject to change. It should not be assumed that recommendations made in the future will be profitable or will equal the performance of securities in this newsletter. The information contained herein is based on internal research derived from various sources and does not purport to be statements of all material facts relating to the securities mentioned. The information contained herein, while not guaranteed as to accuracy or completeness, has been obtained from sources we believe to be reliable. Opinions expressed herein are subject to change without notice. Cheviot Value Management or one or more of its officers may have a position in the securities discussed herein and may purchase or sell such securities from time to time.

The CVM Balanced Portfolio Composite has been examined by independent verifiers for the periods from January 1, 1992 through December 31, 2009. A copy of this examination report is available upon request.

NOTES

[1] Quoted in *Barron's* Round Table, January 24, 2011.

[2] See ''Ben Bernanke's '70s Show,'' by Allan H. Meltzer, Op-Ed, *The Wall Street Journal*, Feb. 5, 2011. Professor Meltzer is author of a definitive history of the Federal Reserve.

[3] Warren Buffett, Chairman's letter, Berkshire Hathaway, Inc. 2010 annual report, pages 3-4.

[4] Interview, "Why America Will Stay on Top" by Brian M. Carney, *The Wall Street Journal*, March 5, 2011.

[5] From "End of the American Era? Don't Count on It," by Victor Davis Hanson, Op-Ed, *Investors Business Daily*, Dec. 31, 2010.

[6] ''GIC's Chief: Americans Too Gloomy on Economy,'' by D. K. Berman, *The Wall Street Journal*, March 7, 2011.

[7] "Washington Awash in Worry Over Debt," by L. Mascaro, *Los Angeles Times*, March 28, 2011.

[8] The ***q*** ratio applies to non-financial corporations. Although the S&P 500 includes financial corporations, in this article when we refer to "the market" or "the stock market" we mean the S&P 500 which comprises about 75% of the total value of the market.

[9] Referred to in "'Tis the Season to be Wary," by Alan Abelson, ''Up & Down Wall Street,'' Editorial Comment, *Barron's*, 12-27-10.

[10] Taking into account adjustments to corporate financial statements that Smithers considers appropriate.

[11] Figures in this article are based on Social Security recipients born 1943-1954. Projections and assumptions will vary for individuals born before 1943 or after 1954.

[12] See "The Consumer Price Index" by Walter J. "John" Williams, Shadow Government Statistics (Oct. 1, 2006), http://www.shadowstats.com/article/consumer_price_index

[13] A number of recent books explain the need for cutting back on social security benefits. See, *e.g.*, Walker, David M., *Comeback America: Turning the Country Around and Restoring Fiscal Responsibility* (2010).

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