CHEVIOT VALUE MANAGEMENT, LLC

INVESTMENT VALUES

Issue Number 118, April 2016

"Physics has three laws that explain 99% of the phenomena, and economics has 99 laws that explain 3% of the phenomena." - Andrew Lo, Finance Professor, MIT

CONTENTS **Page**

OUR INVESTMENT OUTLOOK

A lot happened back on February 11th.

On that day, after more than one billion dollars was invested in decades of experiments, scientists announced that they successfully detected gravitational waves from the merging of two black holes. This massive black hole merger took place at a distance from Earth of roughly 1.3 billion light years and at a time before there were any multi-cellular organisms on our planet. For perspective, the conjoining two black holes were 29 and 36 times larger than the size of our sun while the size of the waves detected on Earth measured one-thousandth the size of a proton. The detection of such gravitational waves, after decades of thought and study, confirmed Albert Eintstein's prediction in his General Theory of Relativity and marked a watershed moment in modern-day scientific discovery.

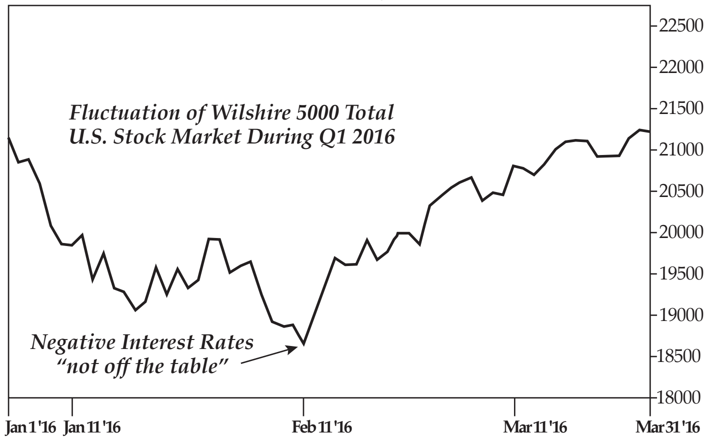
On the same day, February 11th, Federal Reserve Chairwoman Janet Yellen provided semi-annual testimony to Congress on the state of the U.S. and global economy. As a bit of brief background, members of the Fed stated throughout 2015 that the Fed would raise interest rates sometime that year. They also regularly reminded market participants that they would be "data dependent," Fed-speak for raising interest rates only when economic data improved enough to warrant such a move. By the end of the year, the Fed had not yet hiked interest rates – despite saying for more than a year that it would. Unfortunately, by year-end the economic data was weakening, not improving and in mid-December the Fed – to keep its promise and not scare market participants – raised interest rates anyway. Economics is certainly not physics.

Throughout the end of December and all of January, members of the Fed followed that late-2015 interest rate increase by setting expectations that the Fed would raise interest rates perhaps as many as four more times in 2016. Not merely one time and at the last minute as occurred in 2015, but *four* more times. The pace of these hikes spooked financial markets, causing them to drop precipitously such that U.S. and world markets fell by more than 12%.

On February 10th, Yellen tried to reassure the markets that the economy was strong enough for the Fed to continue to pursue its goal of further raising rates in 2016. It would not need to, in Yellen's words, "reverse course" and lower them again. Market participants were skeptical that the economy would not be harmed by higher interest rates. From early in the day on the 10th until the middle of the next day, market prices fell by nearly 4%.

That's when, on February 11th Yellen stated that not only was the Fed not in a hurry to raise

Yellen Speaks Loudly to the Markets



interest rates, it was actually considering something unprecedented in the U.S. "We're taking a look [at negative interest rates] again because we would want to be prepared in the event that we needed to add accommodation [*i.e.*, more monetary stimulus]." She concluded: "I wouldn't take [*negative* interest rates] off the table." The goal of employing negative interest rates would be to cause banks to be more likely to lend money to borrowers (with the hope of spurring business economic activity) and to cause individual savers to be more likely to invest their savings in bonds and stocks (with the hope of pushing up bond and stock prices to make people feel wealthier).

Of more immediate importance, Yellen mentioned that the Fed is considering using negative interest rates as an attempt to stem the decline in the financial markets. She and members of the Fed know that they cannot quickly reverse course and lower interest rates after finally raising them last year for the first time in nine years. The Fed must instead signal to the markets, when prices are falling, that it stands at the ready to help with additional stimulus. Conversely, when prices are rising, there is increased Fed chatter about the possibility of further raising interest rates (a long-discussed Fed goal). The Fed's "dual mandate" of trying to foster employment while suppressing inflation is being exposed as a single mandate of placating the markets.

Yellen, in successfully bandaging the market's wound on February 11^{th}, spurred a market rebound. Now, with valuations relatively high (and these may decline from the gravitational pull of mere talk of higher interest rates) and underlying economic growth tepid, we believe investors should be a little more cautious.

Within the Cheviot family of employees, there are currently 10 children, all of whom are boys.[1] One of which, at four years old, has taken a liking to the game Connect Four. The goal of the game is to string together four consecutive checker-type pieces, either straight or diagonally, before the same is achieved by the opponent. Not surprisingly, there is only so much strategy you can teach a four year-old. One concept that resonates with someone that age is, before placing your piece, seek to block any locations where your opponent can win on their next turn. "Defense before offense," is the mantra. After all, you increase your chances of winning by not losing. (We wish Yogi Berra had said that.)

Given elevated market prices, we are now taking the Connect Four approach to markets . Materially lower prices will enable us to be more bullish and we expect to be ready. In the meantime, we will seek to win by not losing. *Defense before offense.*

THE FINANCIAL DISSERVICE INDUSTRY

"Many in Wall Street – a community in which quality control is not prized – will sell investors anything they will buy." —Warren Buffett

We were inspired to write this article by our examination of numerous recent proposals made to our clients and an examination of similar proposals made to – and the losses incurred by – people recently introduced to us. The turbulence experienced in financial markets since the summer of 2015 seems to have exposed another wide swath of financial advisor misbehavior.

Among much that has been brought to our attention includes proposals of extremely expensive oil and gas limited partnerships that are today worth a fraction of their purchase price, portfolios comprising mutual funds laden with astronomically high fees (one with an annual fee of nearly **8%**!), asset allocations that are for too aggressive for retirees, and more. The so-called "advice" given to individuals is thoroughly upsetting.

When all is going well, these supposed "investment" recommendations are merely expensive relative to similar ways one could invest. When markets decline, such advice can prove disastrous. As Warren Buffett says, "You only find out who is swimming naked when the tide goes out."[2]

There are certainly ethical, trustworthy and competent insurance agents, investment advisors, and financial planners who help their customers invest safely while keeping costs reasonable. We know many such individuals. Unfortunately, mostly through the experiences of clients who come to our firm, we also learn about the practices of countless others in the field who operate with far less integrity.

Commissions: the financial incentive superpower

Repeatedly, we observe that the root cause of the financial service industry's undesirable conduct is spurred by the well-established incentive systems in place at large financial companies. In general, we conclude that the compensation practices of many financial organizations promote employee behavior that maximizes the revenues and profits of the companies and employees rather than promote behavior that maximizes the long-term financial benefit to investors.

Even the revered business mind of Berkshire Hathaway Vice Chairman Charles Munger is continually surprised by the motivational power wielded by financial incentives on the members of the financial services industry. In fact, he places it first on his list of what motivates human conduct. Says Munger: "A man has an acculturated nature making him a pretty decent fellow, and yet, driven both consciously and subconsciously by incentives, he drifts into immoral behavior in order to get what he wants."

An investor's choices

Suppose that you had a considerable amount to invest, perhaps a retirement account, an inheritance, proceeds from the sale of property or a business or your life's savings – but you knew you lacked the expertise to invest appropriately on your own. To avoid losses, you could limit yourself to the safety of U.S government-insured bank deposits or U.S Treasury bonds. However, the trade-off for that safety would be actual interest rates that amount to less than zero after taking into account inflation and taxes.

If you were not satisfied with these negative "real" returns you could get help with investing on your own by looking to the recommendations that are available at little or no cost from books and the financial news media. Or you could find help from advisors in the employ of banks, life insurance companies, securities brokerage firms, or mutual funds, and from self-employed brokers, financial planners, independent investment advisors, and people selling investments in real estate, oil and gas partnerships, etc. This group of individuals is referred to collectively as the "financial service" industry.

Unfortunately, we are finding that many of these individuals lack the true qualifications, deep understanding of financial markets and history, and temperament to dispense competent investment advice. Or is it that these characteristics take a back seat to the financial incentives available to a large number of professionals? For many, and this is based on the portfolios we have analyzed, it appears that their priority is to sell financial products. As someone from another well-known firm told us just days ago, "A couple of the guys in our office were *literally selling men's suits* before they came here."

Costs and expenses of financial products

Life insurance companies, banks, and securities brokers all operate similarly when it comes to selling investments to their customers. Customers often pay a sizable front-end commission when buying an investment product and also pay for ongoing management fees and expenses as long as they are invested in the product. Front-end commissions currently average around 5% of the amount invested. Ongoing annual fees and expenses may range from less than 1% to a little more than 2%.

No-load (*i.e.*, no sales charge) mutual funds selling direct to investors have steadily increased their market share. So, too, have relatively lower-cost exchange traded funds ("ETFs"). If you buy shares from a "no-load" mutual fund there is no up-front charge and annual expenses run around 1% to 1.5% per year on average for equity mutual funds. Ongoing fees are significantly less with some companies, notably Vanguard. However, broker-sold, high-cost mutual funds still represent a large share of mutual fund assets. We frequently see portfolios filled with these expensive funds when we are asked to analyze someone's investment holdings.

Compensation of self-employed independent financial advisors may be either commission-based or fee-based. A key to understanding and evaluating an advisor's recommendations is whether payment is by commission on sale of products or by fees for service. If payment is by commission, then the advisor has an economic self-interest in recommending products which pay a commission, and preferably for the salesperson the highest commission, even though that almost invariably is more costly and thus less beneficial for the customer. The U.S. Department of Labor is now proposing rules to curtail this behavior.

Over the years, a number of household-name brokerage firms and banks have been fined by regulators for salespeople who direct customers into mutual funds that cost the clients more than necessary. This has the effect of reducing returns while providing brokers with higher commissions – an obvious disservice to the firm's customers. Moreover, firms are known to have reduced the pay of their financial advisors if they sell mutual funds other than the company's own funds. This practice limits the available choices and likely increases costs to the investor.

What is financial planning?

Financial planning should be a simple concept: *the process of arranging one's life so as to have the cash one needs when it is needed.* Those needs may include a child's education funding, income replacement in the event of death or disability of the family's breadwinner, and income during retirement.

There are many tens of thousands of financial service industry salespeople out there ready to help others reach their financial goals. And, consistently, their recommendations usually include costly life insurance, expensive annuities, and fee-laden mutual funds, mainly from sources affiliated with or owned by the companies for whom these salespeople work. These advisors also may charge a fee for presenting their recommendations and a yearly fee for as long as a customer owns such products.

Members of the public have a need for trustworthy financial planning advice. Therefore, financial planning advice is increasingly offered on an ongoing annual fee basis by a variety of large financial companies. Most large banks produce their own or are closely affiliated with mutual fund companies that provide a menu of mutual fund choices. If a bank's customer wants advice on how to pick among the bank's mutual funds, the bank will provide personal advice from a financial consultant. Our examination of the experience of others shows that the average cost for such a portfolio amount to more than 2% per annum. This is broken down to approximately 1% for ongoing financial advice on top of at least 1%, which represents the expenses of the mutual funds.

Mutual funds: investment companies or marketing machines?

John Bogle is the founder of the Vanguard group of no-load mutual funds and the innovator of the first stock market index fund. Bogle points out that the industry spends nearly three times as much on marketing as it does on investment management. These marketing expenditures are charged to the mutual fund shareholders, thereby reducing the return on their investment capital. Bogle contends that mutual fund investors are misled by fund marketing, imperiled by the risks, and deluded about the potential returns of funds.

Mutual fund customers unwittingly are subsidizing this misleading marketing via "12b-1" fees levied by many mutual funds to reimburse the fund sponsor for the expense of marketing and distribution (expenses that would be incurred in any event). The 12b-1 charges amount to extra profit for the fund sponsor and less profit for the customers who are harmed, not helped, by significant additions to assets under management by the mutual fund in which they invest. *There are even some mutual funds sponsored by some of the best-known fund management companies that continue to levy 12b-1 charges even after they have closed the fund to investment from new customers thereby eliminating the need for marketing expense.*

Preying upon human nature

Fund companies' large marketing budgets are put to productive use. Says Arthur J. Levitt, former Chairman of the SEC, "a mutual fund's past performance, which is the first feature that investors consider when choosing a fund, doesn't predict future performance. Funds buy expensive ads in newspapers and magazines to tout their performances over the past one, three, five, and ten years. The mutual fund industry irresponsibly promotes this 'culture of performance,' even though it knows perfectly well that it misleads investors."

There is substantial evidence of widespread performance-chasing in mutual funds; i.e., people move into the funds that have been hot recently and abandon funds that have had poor recent results. (This is common across nearly all investment types.) The most active mutual fund shareholders tend to own a fund when it racks up its greatest losses, but not when it has its biggest gains. Therefore, the mutual fund itself tends to perform better than the portfolios of the individuals who own the funds.

"The Market for Financial Advisor Misconduct"

The above subheading is the name of a paper published this past March by business school professors at the University of Minnesota and University of Chicago. The authors of the paper, Mark Egan, Gregor Matvos, and Amit Seru, detailed how prevalent is the misbehavior in the financial services industry.

As high as 20% of advisors at household-name firms have been disciplined for misconduct.

Online databases that provide details of infractions by financial salespeople show that many thousands of violations routinely occur. These violations range from engaging in fraudulent behavior to directing clients into high-fee mutual funds. The authors point out that insurance products are often used to perpetuate such infractions.

"We find evidence suggesting that some firms specialize in misconduct," say the researchers. "Such firms are more tolerant of misconduct, hiring advisors with unscrupulous records. These firms also hire advisors who engage in misconduct."

John Coffee, a professor at Columbia Law School, states: "This is eye-opening and suggests not only that some firms have a high tolerance for misconduct on the part of their employees, but that their very business model is to attract the broker who can generate high revenue at the cost of repetitive disciplinary violations."

Conclusion

We believe that investment advice should be fee-only, not commission-based. Furthermore, we believe that fees for investment advice need not exceed 1.5% on an annual basis and certainly should not cost up to 9%. Financial advisors should recommend for their clients only those investments that have the greatest probability of success, considerate of the risks involved, always opting for the lowest fee alternative, and consistent with being appropriate given the individual client's financial position.

Knowing that so many advisors will not behave this way, individual investors must also educate themselves about the fees associated with any investment product or service. Every investment product prospectus or investment advisory contract must disclose fees inherent in that product or service. We encourage investors to "read the fine print."

Just as in any field, in the financial services industry there will always be slick salesmen pawning high-priced alternatives for financial products of poor quality. Common sense and a thorough understanding of the costs involved almost always yield higher long-term returns for the investor.

In a sad summation of the behavior of financial advisors, Warren Buffett likes to say, "If you take the high road on Wall Street you won't encounter much traffic."

THOUGHTS FROM THE ORACLE

The following are excerpts from a lengthy recent interview of Warren Buffett, the "Oracle of Omaha."

Markets gyrated wildly in the year's first quarter. Was Warren concerned?

I never know what markets are going to do [in the short run]. There's never been a time in my life when I was [able to predict that]. I do know what markets are going to do over a long period of time. They're going to go up. But in terms of what's going to happen in a day or a week or a month or a year, I never felt that I knew it then and I never felt it was important. I will say that in 10 or 20 or 30 years, I think stocks will be a lot higher than they are now.

What is the impact of the low oil price on the U.S. economy?

[In the past year] you had the general thinking that the low price of oil was going to put more money in the pockets of consumers and that was going to cause a pick-up in business and so on.

And it wasn't that… We all learned in freshman economics that if oil went down in price, it was bad for the exporters [of oil] and good for the importers. And certainly, when we had the oil shock back 40 years ago, it was [effectively] a tax on America and the Saudis were leveling the tax.

[Now, with lower oil prices] there's no question that it is good for the country. But what happens is that the benefit to the consumer feeds in slowly. The next time you go to the gas station, you save 15 or 20 bucks. It feeds in very slowly. But the capital values [that are tied to oil and gas investments] disappear immediately.

So if you're sitting with an oil industry in this country that's producing ten million barrels a day at $100 [per barrel], ten million barrels a day is a billion dollars of revenue. That's $365 billion a year. Capital values may be $2 trillion based on that. Now all of a sudden you take [the price of oil] down to where you're not making any money, and the $2 trillion of capital values disappears very quickly, the bank loans against it get sour very quickly.

People lose their jobs in the producing areas… They [the domestic energy companies] quit buying from the service companies very quickly. So the negative effects to this huge capital value decline happen very quickly, whereas [the benefits of lower gas prices are] easing to the consumer very slowly. So even though it's good for the country net… it can be very bad in the immediate effects it has.

Auto insurance companies, including Berkshire Hathaway's subsidiary, GEICO, are seeing more deaths from "distracted driving."

Well, what happened in the insurance business is pretty interesting. For the first time in quite a while… deaths per hundred million miles driven went up. And it's quite interesting. In the 1930s, you were 15 times more likely to die in an auto accident than currently. *Fifteen times.* And then after World War II, the figure got down from 15 per hundred million miles, probably to seven or something like that, per hundred million. And then Ralph Nader came along and cars got a lot safer.

And now it's just a little over one per hundred million. And that number's just kept going down. So we only had a little over 30,000 auto deaths in 2014. But in 2015, for the first time in a long time, the trend started going the other way. And we just got figures from the first nine months [of 2015]. But the frequency of auto accidents went up a lot last year. The number of deaths went up to 32,000, and only about a third are drunk driving. If you think about it, almost 10,000 deaths from 32,000 come from drunk driving. Half of the people were killed as occupants in a car or from not wearing seatbelts. But I personally believe that distracted driving, which was listed for about 10% of the deaths in 2014, I'll bet that number went up a fair amount.

I never know what markets are going to do [in the short run]. I do know what markets are going to do over a long period of time. They're going to go up.
-Warren Buffett

Is cell phone use while driving a culprit?

I really think that's got to be real. There were more miles driven last year too, because gas is cheap. And that has some effect. But beyond that people did not drive as well last year as they had the year before… When you think about it, it's so much safer to drive a car now than when I was a kid, for example.

But in any event, the frequency of accidents, the frequency of deaths per hundred million vehicle miles driven went up quite significantly in 2015. And that's the first time in a long time. And the cars are safer, so people are not driving as well.

As a result, auto insurance rates will continue to increase to cover the rising cost of damages.

You get your policy every six months. So you may not see it for three months until you renew your policy. But rates will have moved up and you will see it as you get renewals. And they've gone up because both the frequency of accidents has gone up and the cost of accidents has gone up.

CREDITS

Darren C. Pollock, David A. Horvitz, and Dixon Karmindro authored this issue of *Investment Values.*

CHEVIOT COMPOSITE DISCLOSURE

Cheviot's Balanced Portfolio Composite (the "Composite") includes all fully discretionary, fee-paying accounts over $250,000 (new account minimum balance is $1,000,000). The Composite assets are allocated principally among the following asset classes: equities (common stocks), fixed income (bonds) and money market funds (cash).

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

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 specific securities identified and described do not represent all of the securities held for advisory clients, and the reader should not assume that investments in the securities identified and discussed were or will be profitable. 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 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 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 time period commencing July 1, 2000 is used as a standard measuring point as that is the date current investment personnel have been active in portfolio management.

The graph on page 8 titled Cheviot Composite Equities vs. S&P 500 compares all stocks within the Cheviot Balanced Composite vs. the S&P 500 Index and the Wilshire 5000 Index (both all-stock benchmarks). Accounts managed by Cheviot are not allocated 100% to stocks at all times, thus no management fees are applied to the data comprising this graph. By describing the performance of Cheviot's selected stocks only, this graph seeks to provide a more apples-to-apples comparison to the S&P 500 and Wilshire 5000.

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. The Wilshire 5000 Index Fund is a fund that closely follows the performance of the Wilshire 5000 Total Market Index. Its return is calculated on a total return basis with dividends reinvested.

Dalbar Inc.'s quantitative analysis of investor behavior produces the actual performance generated by all investors, professional and individual, in U.S. stock mutual funds. The graph on page 8 illustrates this performance over time. This data is made available once per year, in March, to reflect the prior year's actual performance earned by real investors.

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.

The Cheviot Balanced Composite has been examined by independent verifiers for the years 2000 through 2011. A copy of this examination report and further details of our composite are available upon request.

Investment Values is intended to be a source of educational information to Cheviot clients about investments and related topics. Comments about specific securities are NOT intended to be recommendations that readers purchase or sell such securities. Such comments are intended to explain to clients why such securities may have been or may be purchased or sold within a diversified portfolio such as the portfolios of investment clients of Cheviot Value Management, LLC.

NOTES

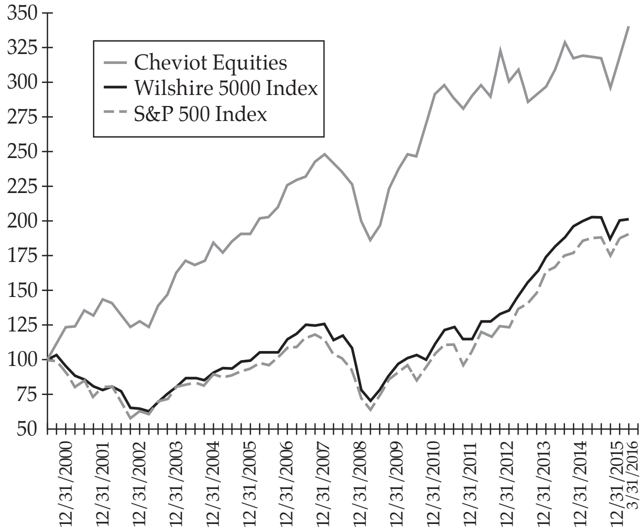
[1]Using 50/50 newborn gender odds, even though we know it is technically closer to 49(female)/51(male), the odds of 10 out of 10 being boys are greater than one in 1,000.

[2]We're more likely to wear multiple pairs of swim trunks.

Cheviot Value Management, LLC

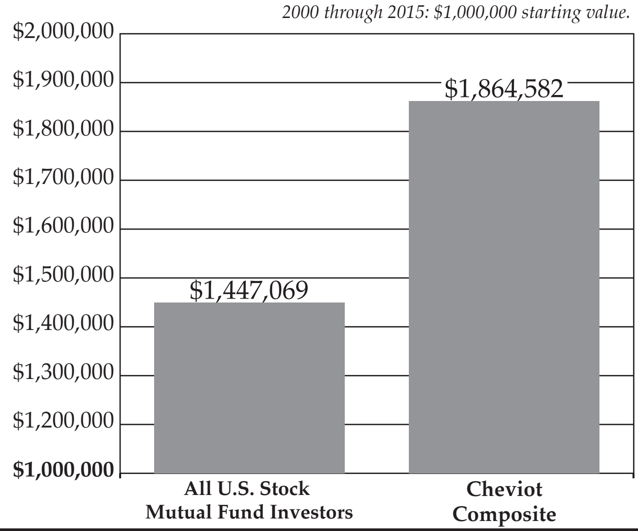
Investment Management • Retirement Planning • Taxation Mitigation • Charitable Giving
Estate Planning • Insurance Advice • Risk Management • Retirement Benefits

Cheviot Equities Long-Term Performance



Investors in U.S. Stock Mutual Funds vs. Cheviot

2000 through 2015: $1,000,000 starting value.



Cheviot's Purpose:

We give our clients peace of mind through safety-first investing, long-term growth, and a steady stream of retirement income. Cheviot prides itself on meeting the long-term financial goals established with our clients and on providing attentive and personal service.

Four principles on which Cheviot was founded:

Integrity:

Put the client first in everything we do.

Liquidity:

Invest in securities that can be bought or sold quickly and inexpensively.

Flexibility:

There are no lock-up periods; clients may access their funds at all times.

Affordability:

Invest for the long-term, minimizing all costs and taxes.

Why Cheviot?

We have decades of independent and unbiased experience, serving clients since 1985.

We invest for ourselves and our families the same way we invest for our clients: We "eat our own cooking."

We do not sell any investment "products" nor are we affiliated with any other financial service companies that do. There are no hidden fees.

We have been recognized by the financial industry's leading publications including, *Barron's*, *The Wall Street Journal*, *Money Magazine*, Yahoo! Finance TV, Fox Business, and the Business News Network.

We maintain the most respected credentials in the financial industry including the Certified Financial Planner (CFP®) designation.

We treat our clients in the way we would desire if our roles were reversed.

9595 WILSHIRE BLVD., PH 1001, BEVERLY HILLS, CA 90212
www.cheviotvalue.com (310) 451-8600 contact@cheviotvalue.com