CHEVIOT VALUE MANAGEMENT, LLC

INVESTMENT VALUES

Issue Number 93, January 2010

"Savings gets us genuine growth; credit expansion gets us boom and bust." – Roger Garrison

"All financial crises are the result of debt that has become dangerously out of scale in relation to the underlying means of payment." – John Kenneth Galbraith

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CURRENT OUTLOOK

The "lost decade" in the stock market

The stock market performed sensationally from mid-1982 through early 2000, so its poor performance since 2000 has prompted the financial media to call the last ten years "the lost decade." There have been previous periods of nearly a decade or longer that were similar to the recent "lost decade," *i.e.* 1906-1921, 1929-1942, and 1966-1974. Such extended periods of flat to negative returns is characteristic of a secular (long-term) bear market.

Ten years ago we were expecting and preparing for an imminent secular bear market and said so in this newsletter. Since then we have protected our clients from losses. The accompanying table shows how our clients generally fared in comparison to the stock market, as represented by the S&P 500.[1] [*Notes appear on page 12.*] Past performance is no guarantee, or even necessarily an indicator, of future results. Nevertheless, we accomplished what we set out to do: protect clients from loss over a down cycle in the stock market.

CVM Balanced Portfolio Composite vs. S&P 500, 2000-2009

	Total Return*	Annualized Rate*
CVM Balanced Portfolio Composite	**+68.88%**	**+5.38%**
S&P 500	-9.10%	-0.95%

**CVM Balanced Portfolio Composite returns are net of transaction costs and investment advisory fees; S&P 500 returns include dividends. See page 11 for information about the construction and performance of the Composite.*

We believe that the reason the stock market has done poorly for the past ten years is because it was way over-priced a decade ago. Regression to mean valuations brings high stock markets down and low stock markets up.

The last ten years' stock market performance looks like a lost decade only because it began at an unusually over-priced level of the market. For the 20- and 30-year periods ending in 2009 the stock market achieved nominal returns of 8.2% per annum (1990-2009) and 11.2% per annum (1980-2009).

Despite a peak to trough drop of 56% in the S&P in 2007-2009, the stock market never reached levels of valuation associated with prior bear market bottoms. In the bear market of 1966 to mid-1982 on several occasions the overall stock market ratio of price to earnings fell below 10x and average dividend yields rose to 6%. To have reached such levels last year would have required the stock market to fall another one-third below the lows

of early last March. The Fed prevented that from happening by issuing a flood of money and reducing interest rates to the lowest levels since the Great Depression of the 1930s. Low interest rates make stocks relatively more attractive, as high interest rates make them relatively less attractive.

The economy

The basic cause of America's current economic woes is a monetary crisis, rooted in over-consumption financed by the lending of money created by credit rather than by saving to pay for future consumption. Excessive expansion of credit has always led to economic booms and busts whenever and wherever it occurs.

The U.S. economy continues to suffer from weakness in retail sales, real estate prices, industrial production and high unemployment. Since at least the mid-1990s America's apparent prosperity has rested on the shaky foundation of ever-rising, debt-financed consumption. Housing and the auto industry are illustrative.

The greatest housing bubble our nation has ever experienced took place in recent years. A principal cause was the forcing up of home prices by mortgage lending to people who were allowed to buy houses with little or no money down, and no proof of ability to pay the loans, so-called "subprime" mortgages. Such mortgage lending became the stock in trade of Fannie Mae and Freddie Mac due to pressure from Congress and the Department of Housing and Urban Development to make "affordable" loans.

It was Fannie, Freddie and other government agencies that directly or indirectly financed most of the reckless mortgage lending that occurred during the housing bubble. Wall Street and credit rating agencies[2] aided and abetted the madness, by packing vast numbers of subprime loans into bond-like mortgage-backed securities (MBS) awarded higher credit ratings than the underlying debt deserved. Fannie, Freddie, and Wall Street communicated America's bad loan disease to other countries. Amazingly, some of the Wall Street firms themselves ruined their own finances by holding large positions in subprime MBS heading into the financial crisis of 2007-2008.

The auto industry, before 2008, had for years been borrowing sales from the future by enticing people to trade in their perfectly serviceable cars in order to buy new cars with zero or low down payment, long-term car loans and leases. Sales of new and used cars are now well below the level of prior years because it has become difficult for car dealers to obtain financing for even creditworthy borrowers.

While economic activity has picked up from the lows of a year ago, America will not return any time soon to the type of debt-financed, consumption-driven activity that preceded and caused our recent economic woes.

The American economy runs on credit and credit is still severely restricted. The loan portfolios of banks of all sizes are filled with loans secured by commercial and residential real estate worth a great deal less then the amount owed by borrowers. Rather than taking risk by making new commercial and consumer loans, bankers prefer to use money borrowed from the Federal Reserve at zero interest to make a risk-free profit by recycling the money into interest-bearing Treasury securities.

The American economy has an extremely strong foundation. Warren Buffett described Berkshire Hathaway's current $44 billion purchase of the Burlington Northern Santa Fe railroad as an "all-in wager on the economic future of the United States."

The U.S. is still the world economic leader in many fields, from the most basic such as agriculture to the most sophisticated such as science and technology. These two seemingly disparate fields are related: American agriculture is the most productive in the world because American farmers are the most highly mechanized and make the most use of advances in science and technology. For example, since 1900 the farm population of the U.S. has fallen from over 40% to 2% of our people because motorized equipment replaced horses and mules for cultivation and harvesting a variety of farm products. And American farmers' crop yields are the highest in the world because of agricultural innovations in chemistry and biotechnology.

While employment in manufacturing has fallen, America remains a world leader in manufacturing sophisticated products such as medical devices, pharmaceuticals, aircraft, equipment for exploration, production and refining of petroleum, etc.

Why we continue to emphasize precious metals

A client recently asked, *"what if your hunch about gold is wrong?"* We explained that we believe it is much more than a "hunch," for the following reasons.

The federal government is on an out-of-control spending spree financed in significant part by the Federal Reserve (the Fed) creating money out of thin air. Last fiscal year (ended September 30, 2009) the difference between federal spending and the total of tax collections and proceeds from sale of Treasury debt was $1.4 trillion, an amount provided by the Fed directly or indirectly creating the money. That is a process known as "monetizing" the debt.[3]

David M. Walker is a former director of the Government Accountability Office and a former Trustee of Social Security and Medicare. He says:

"We suffer from a fiscal cancer…[Federal government] obligations associated with Social Security and Medicare [had] put us in a $56 trillion financial hole [even] before the recession…America now owes more than Americans are worth – and the gap is growing …Our $56 trillion in unfunded obligations amounts to $483,000 per household. That's 10 times the median household income – so it's as if everyone had a second or third mortgage on a house equal to 10 times their income but no house they can lay claim to… Washington is totally out of touch and out of control."

Walker explained that to put the federal deficit for fiscal 2009 into perspective consider that [with a $1.4 trillion deficit] last year's deficit amounted to $2.6 million a minute, $155 million an hour and $3.9 billion a day.[4] The deficit spending will only increase under present government policies, which are forecast to cause $10 trillion in deficits over the next decade.

The federal government continues to rack up big losses in its various bailout operations. For example, Fannie Mae and Freddie Mac, which have financed half the country's residential mortgages, were once ostensibly private corporations, but they went bankrupt in 2008 and were taken over by the federal government. According to Associated Press, in an effort to support the housing market by still more risky lending, "the [federal] government has handed its ATM card to…Fannie Mae and Freddie Mac. The Treasury Department said [on 12-24-09] it removed the $400 billion financial [bailout] cap [on Fannie and Freddie, that] it will provide to keep the companies from failing. Already, taxpayers have shelled out $111 billion to the pair."[5]

Large-scale, prolonged deficit spending has always caused high inflation in every country where it occurred. The U.S. is no exception. Every period in which our federal government ran huge deficits was associated with high inflation. However, the onslaught of high inflation does not occur overnight.

There is little evidence of consumer price inflation over the past year or so. But the wonder is that there has been no *deflation* because credit nearly ceased for a while, most businesses have no pricing power, bankruptcies are rising, and there is an 11% residential property vacancy rate. Furthermore, commercial real estate occupancy, rentals and market values are sagging, and high unemployment is depressing personal incomes.

All of these factors have been counterbalanced by the massive money creation in Washington. That excessive money creation is continually diluting the American dollar, which we believe will cause inflation to be manifested in higher prices to consumers, and – long before that – a rise in precious metal prices and the shares of mining companies.

MONEY WITH INTEGRITY

Recently we were contacted by a lady who sought our advice on whether she should buy gold with a large amount of money she had on deposit in a bank rather than renewing her bank certificates of deposit (CDs) at the current extremely low interest rates. Her concern was not so much the low interest rate, but rather her fear of loss in principal value due to future inflation if she continued leaving her money in the bank.

Our comments started with reviewing the characteristics of money.

1. It is a ***medium of exchange***, in that it is widely accepted in payment for goods and services.
2. It has ***liquidity***, in that it can be converted quickly into any other asset.
3. It is a ***unit of account***, used to measure income, expenses, assets, and liabilities.
4. It is ***store of value***.

The choices available for safekeeping money are more varied and attractive than choosing just between CDs and gold. In a brokerage account, through the mechanism of the stock market, one can own a variety of foreign monies; a variety of commodities including gold, silver, petroleum, etc.; and company shares, including some that pay significant income to investors via dividends.

Each of these investments has two important characteristics of money: they are a store of value and usually they are liquid. One can own any and all of these money-substitutes via an Exchange Traded Fund (“ETF”). An ETF is a marketable security that trades on a stock exchange and holds assets such as a stock index, currencies, and commodities.

Of course, there is volatility in market value for the assets described immediately above, but such volatility can be controlled and limited by portfolio management, and is a tradeoff for avoiding potentially unacceptable loss of capital via inflation.

Money is a useful medium of exchange *if* the money is widely accepted. In ancient Greece and Rome some 2,500 years ago, people settled on the use of gold and silver coins as money because of the relative scarcity and desirability of these metals. Today money takes a variety of forms, including checks written on a bank account, credit cards, debit cards, and smart cards.[6] Credit cards, debit cards and smart cards eliminate the need to carry around cash for payments of any size, large or small.

There are nearly 200 national monies in the world, almost as many as there are nation-states. Money that loses value rapidly is not a reliable store of value and for this reason can scarcely be considered money at all, as it will cease to be widely accepted as a medium of exchange.[7]

Today, every nation in the world issues fiat money. The word “fiat,” medieval Latin for “let it be done,” signifies a political law asserting a state monopoly on issuance of money that is backed up by nothing but the state’s power, and requiring acceptance of the state-issued money in payment of all debts.

From 1900 to 1933 the U.S. dollar (USD) was not a fiat money because it was backed by the promise of the U.S. to redeem its paper money with gold.[8] We don’t expect to see the gold standard again because no government would now accept its necessary limitations on money creation.

Throughout history governments have regularly confiscated some of the wealth of their citizens by debasing fiat money, in earlier times by reducing the precious metal content of coins and in recent times by excessive expansion of the supply of money by printing paper money or most recently by electronic means. When the debasement becomes unacceptably high, people find other money to use.

After the United States became a large and wealthy country – with a history of stable value for its money – the U.S. dollar became widely used as money in other countries, as it is even today, for example in Venezuela where annual inflation is 25% with a thriving black market in dollars at a large premium to the state’s official exchange rate.[9]

When the U.S. became the world’s wealthiest and most powerful country, our dollar supplanted the British pound sterling as the world’s preeminent money, the “reserve currency” that is held in significant quantities by many governments and institutions as part of their foreign exchange reserves and which serves as the international pricing currency for products traded on a global market, such as oil, gold, etc.

In 1933 the U.S. ceased backing its money with gold. Without the discipline of the gold backing the U.S. government was free to debase its paper fiat money, and did so. The loss in value of the USD as represented by the continually rising price of goods and services may be indicated by the Consumer Price Index (CPI). In terms of the CPI, since 1933 the USD has lost 94% of its value; thus, in 2009 $100 had the buying power of $6 in 1933.[10]

Today, due to our federal government’s persistent debasement of the USD, other countries are

openly discussing the desirability of replacing the dollar as the world's reserve currency.

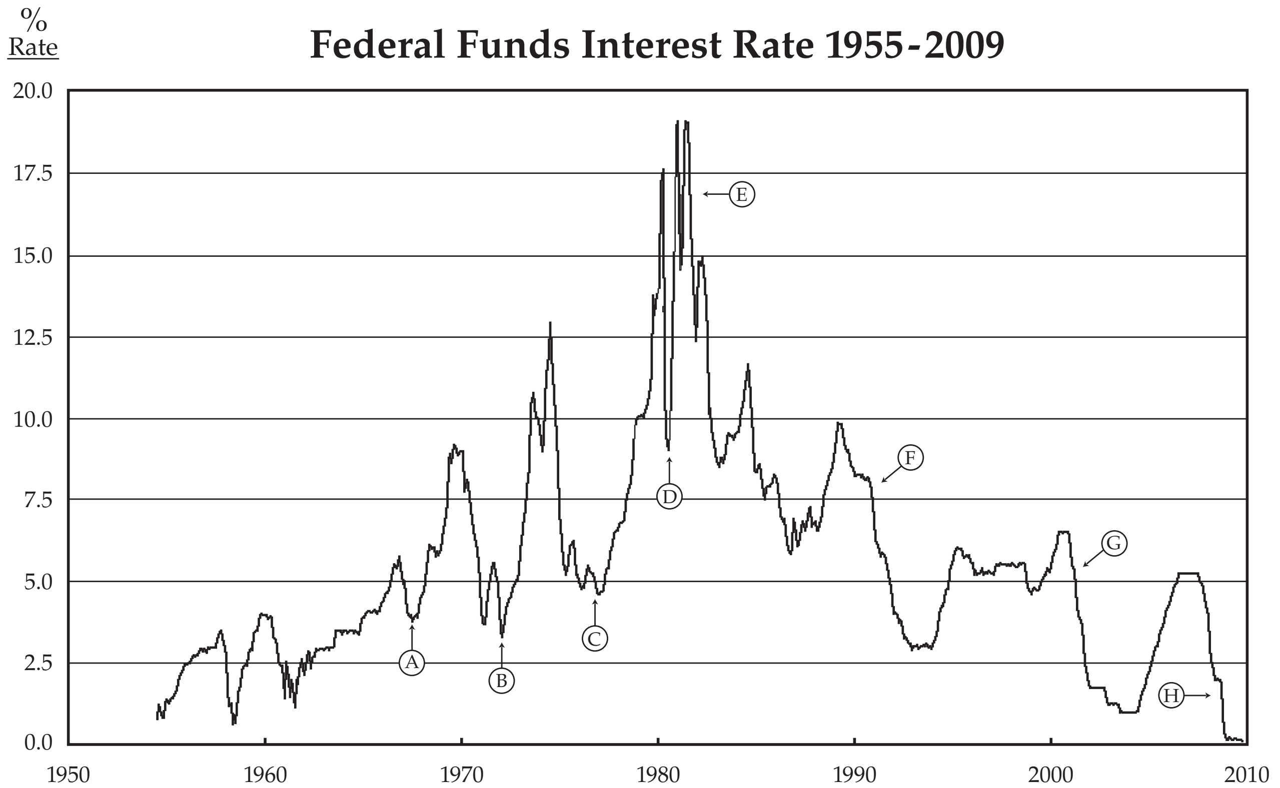
Like any other nation, our federal government can finance its spending in four ways: taxes, borrowing, sale of assets (a rare thing), and inflation. Our country's Central Bank, the Federal Reserve, was established to provide stability to the banking system, although its activity in recent years has been cited as a major cause of financial instability.[11] A leading expert on the history of the Fed, Professor Alan H. Meltzer, recently opined that the U.S. is now headed toward another financial crisis due in part to the monetary policies of the Fed.[12]

The Fed, with its power to create fiat money at will, has become the agency through which the federal government debases the USD via inflation. Of state-caused inflation, famed economist John Maynard Keynes said:

"It is common to speak as though, when a Government pays its way by inflation, the people of the country avoid taxation…[T]his is not so. What is raised by printing [fiat money] is just as much taken from the public as is a beer duty or an income tax. What a Government spends the public pays for."[13]

The accompanying graph illustrates the history of American inflation since 1955. The graph shows changes in the Fed funds interest rate.

The Fed controls the national money supply by setting the Fed funds rate for inter-bank borrowing and by "open market operations" (buying and



Source: Federal Reserve Bank of St. Louis

A 1968 Presidential Election	E Paul Volcker at the Fed
B 1972 Presidential Election	F 1989-1993 Banking Rescue
C 1976 Presidential Election	G 2001 Recession; Post 9/11
D 1980 Presidential Election	H 2008 Financial Crisis

selling Treasury Securities). Increasing the supply of money by buying Treasury securities while reducing interest rates stimulates economic activity; decreasing the supply of money by selling Treasury securities while increasing interest rates restricts economic activity.[14]

If this over-simplified description of how the Fed works is not clear, suffice it to say that changing the Fed funds rate plays a major role in the Fed's ability to increase or reduce inflation.

Since 1955 the U.S. has been in four wars and has expanded or launched new and expensive social welfare programs.[15] War and social welfare programs are the chief reasons the federal government has used inflation to spend more than it was willing or able to raise by taxing and borrowing.

While the Fed is ostensibly an independent agency, its members have yielded to the pressure of presidents to inflate the money supply for purposes of stimulating the economy in the run-up to a presidential reelection bid. This is illustrated in the graph; it occurred in every presidential election between 1968 and 1980, under Presidents Johnson, Nixon, Ford and Carter.

When the rate of inflation reached 12% in 1979, a new Fed chairman, Paul Volcker, persuaded the Fed to take decisive action to curb inflation. Starting in 1979, with a brief timeout for President Carter's 1980 reelection bid, the Volcker Fed raised interest rates and tightened credit via open market operations. These actions contributed importantly to the biggest economic downturn since the 1930s. Sky-high interest rates restricted borrowing and consumption. Unemployment rose to 10.8% by late 1982.

The economic recession made the Volcker anti-inflation polices highly unpopular, but Volcker was able to persist because the public had come to fear high inflation. By 1983 the distasteful medicine was starting to work; the recession ended and inflation was falling. By the end of Volcker's tenure at the Fed in 1987, the Fed funds rate had fallen from a peak of nearly 20% to less than 7% and inflation, as measured by the CPI, had fallen from 13.5% in 1980 to 3.7% in 1987.

During the tenure of Alan Greenspan as Fed chairman (1987 to early 2006) the Fed cut interest rates and enlarged the money supply in 1987 in an attempt to halt the 1987 stock market crash, in 1989-93 to help the banking system recover from the disastrous banking crisis of the late 1980s, in 1999 to avert anticipated Y2K problems,[16] and from 2001-2004 to combat economic recession. Under new Fed chairman Ben Bernanke, to combat the latest financial crisis, in 2007-2008 the Fed cut the Fed funds rate from 5.25% to a range fluctuating between zero and 0.25%.

The Fed's most recent actions have reduced interest rates for the safest short-term investments to historically low levels, ranging from near zero for demand bank deposits and money market mutual funds to no more than 1.5% for shorter-term Treasury securities, federally insured CDs and investment grade bonds.

All fiat monies are inherently unreliable as a permanent store of value because of the temptation of political states to spend beyond their means, which causes inflation and the debasement of the national money.

However, just as the U.S. dollar became the world's reserve currency spontaneously, in part because it *was* a store of value, a celebrated economist has predicted that there will arise spontaneously a number of competing, commodity-based, non-fiat monies issued by private banks. The attractiveness of such monies would be promoted by competition for business based on the integrity of such monies as a store of value.[17] This is already happening even with fiat money, as evidenced by the international currency markets where fiat monies rise and fall in relative value in accordance with the degree of their stability.

AMERICA'S MORAL HAZARD ECONOMY

Underlying our emphasis on precious metals in our investing is the existence of societal incentives for irresponsible behavior that appear to have caused the recent financial crisis and that undermine the future purchasing power of the U.S. dollar.

This article was inspired by an essay of David Goldhill in which he addresses the runaway

escalation in health care spending. Goldhill points out the enormous cost to society from the moral hazard of generous health insurance benefits, namely "the tendency we all have to change our behavior, becoming spendthrifts and otherwise taking less care with our decisions when someone else is covering the costs."[18] Thus, it is a well-documented fact that people who are insured only for catastrophic medical expense (called "major medical" insurance) spend far less on health care than people whose insurance covers most costs.

Income tax deductions for employer-paid health insurance and tax-free benefits for employees encourage over-insurance which drives costs upward. Because of low deductible and low co-pay features of such insurance, the true costs of health care are hidden from the recipients. Consequently, competition based on price and quality is virtually impossible and consumers are unable to be the ultimate judges of value, a state of affairs that appears unlikely to change any time soon.[19]

Moral hazard exists also when people can profit from risky activity without fear of loss from such activity, or generally, when the *disincentives* to risky behavior or dishonesty are far outweighed by the incentives. For example, a new book on the recent financial crisis recounts how one Citigroup mortgage bond trader responded to a co-worker's worry about the risks of a downturn in the housing market: "What's the worst that could happen? We make $200 million and then we get fired."[20]

This anecdote exemplifies but does not reveal fully the moral hazard causation of the recent financial crisis. Moral hazard is more far-reaching than greed on Wall Street. It is embedded deeply in our society. Savers can patronize banks paying the highest interest on deposits because federal government bank deposit insurance obviates the need for savers to avoid risky banks. Federal law encourages, even compels risky mortgage lending, provides money to lenders, and the federal government directly or indirectly insures almost all bank lending.

The federal government bails out the largest banks on the premise they are "too big to fail," meaning the government doesn't want to take them over and operate them, except where it has to, as in the case of Fannie Mae and Freddie Mac. No one but the taxpayers has much, if any, risk for the gargantuan losses from residential real estate lending, not the legislators and regulators, not the bankers, and not the savers whose money was funneled into bad loans.

Social welfare and pension programs are hopelessly beyond the means of the taxpayers to finance at every level of government, federal, state and local. At the federal level, government debt plus unfunded entitlement program liabilities are in aggregate 10x the median annual household income, and growing, according to a man who was formerly the Director of the U.S. Government Accountability Office and a Trustee for Social Security and Medicare.[21] Moral hazard is the cause of this enormous debt.

To bolster their chances of continual reelection, federal, state, and local lawmakers make pension and health care promises they themselves don't have to keep. Experts in and out of government have been advising the lawmakers for decades that these promises cannot be kept over the long term. But, lawmakers disregard this advice, evidently operating under the implicit premise that these programs are politically attractive now, and they will be retired from office or deceased by the time the problems they have created become overwhelming.

None of these problems is obscure or insoluble. There are solutions. Excellent books have been written by people who are knowledgeable, analyzing the problems and proposing feasible solutions.[22]

ROTH IRA CONVERSION

Until January 1, 2010, Congress imposed income limitations on taxpayers' ability to convert traditional IRA assets to Roth IRA assets. Through 2009, taxpayers with modified adjusted gross income (MAGI) of not more than $100,000 were entitled to convert all or a portion of their traditional IRA accounts into Roth IRA accounts, and those with MAGI of more than $100,000 were not eligible to convert at all. As of January 1, 2010, however, as provided in the Tax Increase Prevention and

Reconciliation Act of 2005 (TIPRA), Congress has eliminated this limitation, allowing all taxpayers the privilege of converting their traditional IRA to a Roth IRA, regardless of income.

Under the traditional IRA arrangement, contributions made to the IRA are deducted from income in the year contributed. These contributions are allowed to grow, free of tax, until withdrawn, at which point the participant pays ordinary income tax on the withdrawal. Under the Roth IRA arrangement, the participant receives no tax deduction in the year of contribution but does not pay income tax upon withdrawal. As with the traditional IRA, assets in a Roth IRA are allowed to grow tax-free.

Prior to 2010, eligible taxpayers who elected to convert their traditional IRAs to Roth IRAs paid income tax on the converted assets in the year of conversion. In 2010, taxpayers who elect to convert their traditional IRAs to Roth IRAs have the option to pay income tax in equal parts over the years 2011 and 2012 (however at their 2011 and 2012 marginal tax rates, respectively).

To convert, or not to convert?

There are a number of important factors that must be taken into consideration before one converts all or part of his or her eligible IRA accounts.

Taxes: The most important factor to take into consideration before converting all or part of one's eligible accounts is taxes. A conversion rarely makes sense if the taxpayer will be in a lower tax bracket in the future, when he takes distributions from his account, than he is at the time of conversion. Conversely, if the taxpayer knows he will be in a higher tax bracket during the distribution years, a Roth conversion may make sense. For example, if a taxpayer elects to convert $100,000 of traditional IRA assets to a Roth IRA, and he is in the 35% tax bracket at the time of conversion, he will pay $35,000 in taxes at the time of conversion. If the same taxpayer would only be in the 25% tax bracket at the time he takes distributions, he would have had to pay only $25,000 in taxes, had he not elected to convert to a Roth IRA.

Federal income tax rates are at 80-year lows. The top rate is 35%, compared to top tax rates as high as 91% from World War II until 1964, 70% in 1981, and 50% in 1986. Converting to a Roth IRA may help protect retirement assets, *if* rates should rise in the future.

Affordability: Taxpayers must pay income taxes on the conversion amount. Taking a distribution from the IRA in order to pay the taxes on the conversion vitiates the effectiveness of the conversion, since the goal is to shelter as much money in the tax-free vehicle as possible. If the only source of cash to pay the income tax is to tap the IRA itself, the taxpayer loses the potential benefit of tax-free growth on that amount. Plus, if the taxpayer is under 59½ and taps an IRA to pay the tax, there will be a 10% excise tax. Therefore, it is imperative that the taxpayer have the funds available from an outside source to pay the conversion taxes.

Time Horizon: Taxes paid today represent an opportunity cost to those same dollars left to grow invested in a taxable account. In order for the Roth conversion to be worthwhile, the taxpayer must have a sufficient time horizon over which the Roth funds can recoup the funds lost to ordinary income taxes. Keep in mind that the ongoing return on funds invested in a taxable account are diminished somewhat by taxes on dividends and interest and long-term gains at liquidation.

Eventual use of the funds: For estate planning purposes, a Roth conversion could provide substantial benefits to one's heirs, provided the taxpayer does not need access to the converted funds throughout his lifetime. For example, consider an investor who will not need the funds in his IRA for living expenses in retirement. A Roth conversion may make sense, as he would be able to bequeath his Roth IRA as an asset that grows tax-free to his heirs. This approach may be particularly beneficial if the heirs who inherit the Roth assets are in a high tax bracket themselves when they receive the inheritance.

Origin of the funds: IRAs funded with after-tax contributions (also known as non-deductible IRAs) are prime candidates for a Roth conversion. Since only the earnings on these IRA assets would be taxed as ordinary income at withdrawal, converting early, when the earnings represent a lesser proportion of the account value may be wise. Furthermore,

since taxes on these funds have already been paid, the conversion may be tax-exempt. (Note: the IRS requires all IRA assets to be aggregated in calculating the tax-exempt conversion amounts.)

Partial conversions

A taxpayer may be wise to make a partial conversion of an IRA, rather than to convert the full amount. A partial conversion may make sense when the converted amount conforms to a lower tax bracket and/or when the taxpayer does not have the funds to pay the taxes from an outside account. A strong argument could be made for making a partial conversion, even in the circumstance where the taxpayer can afford to pay the taxes on more than the converted amount from an outside source. It is articulated by Dr. William Reichenstein, Ph.D, CFA. Dr. Reichenstein notes: "Since nobody knows for sure what future tax rates will be . . . a partial conversion [will allow the tax payer to maximize tax benefits in the withdrawal years.]"

For example, assume a retiree has a number of retirement accounts from which he can draw funds in his retirement. In years in which his income from sources other than his IRA is high, he can take withdrawals from his Roth to supplement his income without launching himself into a higher tax bracket. In years in which his income is low from sources other than his retirement accounts, he can take distributions from the taxable accounts to supplement his income without launching himself into a higher tax bracket.

A healthy skepticism about "tax-tree" Roth distributions

Edward F. McQuarrie, Ph.D., a professor at Santa Clara University's Leavey School of Business writes: "The idea that Congress will never change today's Roth provisions for the worse, for the rest of your life and the life of your heirs, requires more faith than reason, and a naïveté that would be touching if it wasn't so dangerous to your financial well-being."[23] Dr. McQuarrie suggests Congress could impose a tax on what it would deem "excess" Roth accumulations, taxing Roth balances above a certain threshold.

While the prospect of tax-free distributions at some point in the future may sound appealing, whether or not they will actually be tax-free remains to be seen. Taxes due on Roth conversions today are certain.

Summary

High-income taxpayers who will become eligible for Roth conversion in 2010 are least likely to benefit, because they are already in the highest tax bracket. If a Roth conversion did not make sense prior to 2010, it likely will not make sense afterwards. Conversion for estate-planning purposes may make sense.

As with most matters involving the income tax, Roth conversions are complicated. Taxpayers should discuss the ramifications of conversion with their tax advisors and financial advisors.

ANNOUNCEMENT AND CREDITS

Effective January 1, 2010 our business is being operated as a limited liability company under the name Cheviot Value Management, LLC (the LLC). Darren C. Pollock and David A. Horvitz have become members of the LLC with a proprietary interest, together with Frederic G. Marks and Nancy J. Marks.

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 Aldus Digital Graphics, Inc. of Los Angeles.

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 December 31, 2009 we initiated an investment in shares of **Verizon Communications (VZ)**; there were no other changes to the Composite.

Verizon Communications (VZ) was created by the merger of Bell Atlantic and GTE in 2000. The company traces its history back to 1879. VZ is a diversified telecommunications company providing wireline and wireless telephone, cable TV and Internet service. It employs over 220,000 people and serves more than 140 million access line equivalents (wireline, wireless, cable TV and Internet) and is the leading wireless company with more than 89 million wireless customers, a wireline (landline) presence in 28 states and Washington, DC and wireless presence in all 50 states and Washington DC.

While not a guarantee of future performance, VZ has provided good long-term returns to shareholders in the past, with real (inflation-adjusted) returns averaging nearly 9% a year since 1954 including dividends. Dividends have been paid continuously since 1936. The company has strong finances, an excellent credit rating, and the capacity to continue to pay and gradually raise its dividend over time.

We were able to buy shares of this high quality company at what we believe was a relatively low price because last year such stable, high quality companies were out of favor in the quest for fast profits which favored higher risk, lower quality companies.

We think long-term prospects for VZ are good in the highly competitive market for wireless phone service. VZ appears to be one to two years year ahead of AT&T in building a 4G (fourth generation) network. 4G networks meet higher standards for capacity (serving more simultaneous users per cell), providing a smooth transition across heterogeneous networks and better Internet and multimedia access.

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 12/31/09.

	1-year	3-year	5-year	8-year	10-year	Since Inception: 12/31/91
CVM Balanced Portfolio Composite	10.94%	2.86%	4.10%	3.88%	5.38%	7.02%
S&P 500 Index	26.50%	-5.64%	0.40%	1.58%	-0.97%	7.73%

Composite Portfolio Holdings as of December 31, 2009

Security	Pct. Assets
Market Vectors Gold Miners ETF	8.0
Berkshire Hathaway	7.4
Newmont Mining	6.7
Federated Prudent Global Income Fund	6.3
Federated Prudent Bear Fund	5.5
Pan American Silver	5.0
Pfizer	4.6
Central Fund of Canada	3.8
Leucadia National	2.8
Johnson & Johnson	2.7
Wrigley Bond, 4.3%, due 7/15/2010	2.6
Medtronic	2.5
UnitedHealth Group	2.5
Wal-Mart Stores	2.4
Stryker	2.2
Bristol Myers-Squibb	1.8
Walgreen	1.6
Eli Lilly	1.6
Zimmer Holdings	1.4
Amgen	1.3
Markel	1.3
Microsoft	1.3
Abbott Laboratories	1.1
ConocoPhillips	1.1
Berkshire Hathaway, 7.125% due 10/15/2023	1.0
Chevron	1.0
Verizon Communications	0.8
Washington REIT	0.5
Newmont Mining, 8.625% due 5/15/2011	0.5
Kaiser Permanente, 3.450% due 5/1/2011	0.5
Other	1.5
Cash Equivalents	16.7
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, 2008. A copy of this examination report is available upon request.

NOTES

The quotations at the top of page one are, respectively, from a Professor of Economics at Auburn University (Roger Garrison) and one of the most influential economic historians of the twentieth century (John Kenneth Galbraith).

[1]Standard & Poor's S&P 500 Index consists of 500 companies with publicly traded shares that, in aggregate, represent about 75% of the total value of all publicly traded U.S. shares.

[2]Most notably S&P, Moody's, and Fitch.

[3]Direct monetization occurs when the Fed, which has no assets, "buys" federal debt; indirect monetization occurs when the Fed lends to banks at near zero interest and the banks use the funds to buy interest-paying federal debt.

[4]See "Warning! The Deficits Are Coming," Interview of David M. Walker by John Fund, *The Wall Street Journal,* 9-4-09, http://online.wsj.com/article/SB10001424052970203585004574392620693542630.html

[5]"Fed Removes Cap for Fannie, Freddie Aid," by J. W. Elphinstone, AP, 12-24-09 http://www.time.com/time/nation/article/0,8599,1950083,00.html#ixzz0cGh2q8Kl and "The Biggest Losers," *The Wall Street Journal,* Editorial, 1-4-10, http://online.wsj.com/article/SB20001424052748704152804574628350980043082.html#mod=todays_us_opinion

[6]A smart card is a plastic card about the size of a credit card, with an embedded microchip that can be loaded with data, used for telephone calling, electronic cash payments, and other applications, and then periodically refreshed for additional use.

[7]Most of the world's 195 nation-states issue a national money. A few countries use the U. S. dollar as their money, including Ecuador, East Timor, Panama, and several small island nations in the Caribbean Sea and Pacific Ocean. In Zimbabwe, hyperinflation has caused residents to abandon their national currency in favor of the US dollar, British pound, Euro, South African Rand, and the Pula of neighboring Botswana. See http://geography.about.com/cs/countries/a/numbercountries.htm; and http://en.wikipedia.org/wiki/List_of_circulating_currencies

[8]Some U.S. paper money was backed by silver from 1878 to 1964.

[9]See "Venezuelans rush to empty their devalued pocket books," by M. Mogollon and C. Kraul, *Los Angeles Times,* 1-12-10.

[10]See the U.S. Bureau of Labor Statistics CPI inflation calculator at: http://www.bls.gov/data/inflation_calculator.htm

[11]See *Greenspan's Bubbles: The Age of Ignorance at the Federal Reserve* (2008) by William A. Fleckenstein; "Chairman Bernanke's Monetary Apologia," by Judy Shelton, Op-Ed, *The Wall Street Journal,* 12-9-09, http://online.wsj.com/article/SB20001424052748704842604574642153438387892.html#mod=todays_us_opinion

[12]"Preventing the Next Financial Crisis," by Alan H. Meltzer, Op-Ed, *The Wall Street Journal,* 10-23-09, http://online.wsj.com/article/SB20001424052748704224004574489251193581802.html#mod=todays_us_opinion. Prof. Meltzer is the author of a multi-volume history of the Federal Reserve since its inception in 1913 through 1986.

[13]From Keynes' *Tract on Monetary Reform* (1923), quoted in "Loose Money and the Roots of the Crisis," by Judy Shelton, Op-Ed, *The Wall Street Journal,* 9-30-08, http://online.wsj.com/article/SB122273029076687929.html

[14]The federal government shares control of the supply of money with commercial banks that can "create" money by making loans, having an effect on money supply similar to the Fed creation of money in open market operations. The Fed can restrict or encourage bank lending by raising or lowering the Fed funds rate, but nevertheless the Fed does not have complete control of the money supply.

[15]Social Security, Medicare and Medicaid are the largest social welfare programs but there are many others, including mandated spending on Medicaid by the states, which cumulatively add up to large and growing annual expenditures of which most members of Congress are unaware. See Gross, Martin L., *National Suicide: How Washington Is Destroying the American Dream from A to Z* (2009), pages 9-11.

[16]For fear that older computers could not adapt to the need to use four digits for the date of years after 12/31/1999, the Fed flooded the economy with money as a precautionary action to prevent economic problem consequent to computer breakdowns.

[17]See Hayek, F. A., *Denationalisation of Money* (2nd ed. 1979). In this 140-page monograph, Hayek, the 1974 Nobel Laureate in economics, explores in depth the disadvantages of fiat money and central banking; and explains the advantages and possible method of operation of competing, private issue monies.

[18]See "How American Health Care Killed My Father," by David Goldhill, *The Atlantic,* September 2009, http://www.theatlantic.com/doc/print/200909/health-care (discussion under heading "The Moral-Hazard Economy").

[19]David Goldhill, note 18 above, text following heading "The Limits of 'Comprehensive' Health-care Reform"; and "Health 'Reform' Gets A Failing Grade," by Jeffrey S. Flier [Dean, Harvard Medical School], Op-Ed, *The Wall Street Journal,* 11-18-09, http://online.wsj.com/article/SB10001424052748704431804574539581994054014.html

[20]Quoted in "The Road to Ruin," by James Freeman, *The Wall Street Journal,* 11-3-09, a review of the book *The Sellout: How Three Decades of Greed and Government Mismanagement Destroyed the Global Financial System* (2009) by Charles Gasparino.

[21]See comments of David M. Walker above, at page 3.

[22]See, *e.g.*, *The Coming Generational Storm: What You Need to Know about America's Economic Future* (2004) by Lawrence J. Kotlikoff; *Putting Our House in Order: A Guide to Social Security and Health Care Reform* (2008) by George P. Shultz and John B. Shoven; and *Come Back America: Turning the Country Around and Restoring Fiscal Responsibility* (2010) by David M. Walker.

[23]Quoted from "Breaking Faith on Savings Is Very Easy," by Edward F. McQuarrie, *Barron's* (Other Voices), March 5, 2007, http://online.barrons.com/article/SB117288159288925437.html?mod=9_0031_b_this_weeks_magazine_main

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