CHEVIOT VALUE MANAGEMENT, LLC

INVESTMENT VALUES

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"Americans who have done everything right, have worked hard, saved their money and stayed out of debt are the ones being punished by low interest rates." – Richard Fisher

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CURRENT OUTLOOK

Debt and Deficits

There is political debate now about the refusal of Congress, at least so far, to raise the limit on federal debt, raising concern of economic havoc if the U.S. were to stop payments on its debt. We have no doubt that the debt limit will be raised soon, as it has been many times in the past. We believe that the limit on national debt is a fiction created by the Congress and successive Presidents to project an image of financial responsibility that is actually totally lacking. The essence of the current debate is not about the debt limit, but about how to keep future federal spending to a sustainable level.

The federal government now has an acknowledged "public debt" of $14.3 trillion, but there are also additional unfunded liabilities of about $48 trillion for future costs of entitlement programs including Medicare, Medicaid and Social Security. The $62 trillion total federal debt exceeds the total net worth of American households.

It is a positive sign for America that responsible members of the federal government are aware that the U.S. must mend its financial ways. A bi-partisan commission appointed by the President in 2010 warned that the U.S. must depart from its present course of spending because it would be unsustainable even with far higher taxation. Recently, ten former chiefs of the Council of Economic Advisers, from both parties, published an open letter warning that if the U.S. does not get its national debt under control, the result will be a crisis that could dwarf that of 2008. Furthermore, it appears that a majority in both the Senate and House of Representatives now favor spending cuts.

Gasoline prices

On June 23, 2011 the U.S. and 27 other countries agreed to release 60 million barrels of oil from strategic reserves. The official announcement said this was being done to prevent tight oil supplies from undermining "the fragile global recovery."

The U.S. Strategic Petroleum Reserve (SPR) was created to assure supplies in case of a supply interruption such as the OPEC oil embargo of the 1970s or a horrific natural disaster. Since there has been no recent reduction in petroleum supply, it appears that in the U.S. the SPR release was aimed at lowering gas prices and creating another form of economic stimulus. This is only the third time that the SPR has been tapped, the others being during total cessation of supply from Iraq and Kuwait following the 1991 Gulf War and the disruption of supply from the Gulf of Mexico due to hurricanes in 2005.

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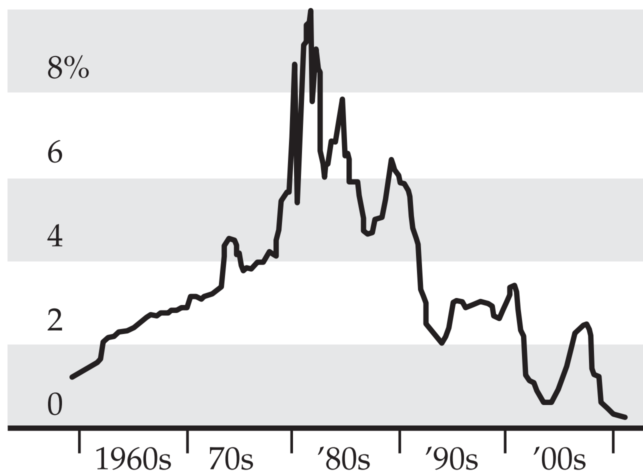
Inflation is a large component in the rise of gasoline prices to the $3.84 per gallon recent national average retail price. Petroleum sells for U.S. dollars on the world market, so petroleum producers raise the price in dollars as the dollar loses value due to inflation in the U.S. Had there been zero increase in the CPI the past 25 years, then the current average retail price of gasoline in America could be around $1.80 per gallon.

Financial assets

The accompanying graph shows that interest rates on cash are at 50-year lows. Interest rates last were at zero on short-term Treasury obligations in the last years of the Great Depression.

Cash Equivalent Interest Rates 1960-2010

Average interest rates on short-term bank deposits, CDs, and money-market mutual funds



Source: Federal Reserve Bank of St. Louis

Savers are being punished with negative real (inflation-adjusted) interest rates. In the unreal world of federal government statistics, there was no consumer price inflation last year. However, in the real world, prices continued to rise for essential goods and services such as gasoline, health care, food, college tuition, etc. Nevertheless, with financial markets in our opinion somewhat overpriced, we believe it preferable to suffer a real, but relatively small short-term loss on cash via inflation compared to taking on excess risk in most bonds and stocks whose prices have been inflated by policies of a Federal Reserve (“the Fed”) intent on stimulating the sluggish economy. Generally, bond yields are extremely low; inevitably bond prices will fall when interest rates rise.

Over the past six years investors have been well rewarded by commitments to precious metals related securities. Although market prices of precious metals and related securities have come down some recently, in our view they remain an attractive financial asset given the Fed’s strong commitment to policies that seem likely to debase further the purchasing power of paper money.

MONEY MARKET FUNDS: Safety is paramount

Unlike most securities that fluctuate in price, a money market mutual fund seeks to maintain a stable value of $1.00 per share. The interest rate offered by the fund fluctuates.

The banking crisis of 2008 at the time of the collapse of Lehman Brothers caused the share price of a prominent money market fund to fall below $1.00 (“breaking the buck”). Such a loss was unprecedented for a publicly traded money market fund. At the worst point in the crisis, holders of this money market fund were offered 97 cents on the dollar and were unable to withdraw their funds for one week. Government safety nets were then extended to money market funds, but have since been withdrawn.

Currently, the ten largest U.S. money market funds have 50% of their capital tied up in European bank debt. While we cannot forecast all potential ramifications, debt restructurings in Europe could cause losses on European bank debt held by American money market funds.

With safety our chief concern, currently we favor money market funds that invest solely in U.S. Treasury obligations. Warren Buffett’s Berkshire Hathaway keeps all of its large cash holdings in short-term Treasury obligations because as Mr. Buffett says: “It’s a parking place and we want our car back when we’re done parking.”

HAS THE FED CEASED ITS EASING WAYS?

On June 30, 2011, the Fed ended its second round of "quantitative easing" ("QE2"). Quantitative easing is the euphemism for a policy whereby the Fed creates new money with which to buy mortgage-backed securities and U.S. Treasury debt. The goal of purchasing mortgage-backed securities was to stabilize a sinking real estate market; buying Treasury debt was an effort to prevent rising interest rates from entering the economy. Whether or not the Fed resumes QE will have a critical impact not only on the U.S. economy, but also the global economy.

The Fed seeks to inhibit economic activity when the general business climate is overheating. In the words of William McChesney Martin, Fed Chairman from 1951 through 1970, the Fed should "take away the punch bowl just as the party gets going."

When economic activity slows down markedly, Fed policy has been to create economic stimulus by reducing short-term interest rates. This is called "easing" or "monetary easing," since low interest rates create "easy" money to lubricate the wheels of finance and industry. American – and global – economic activity deteriorated rapidly during the financial crisis that began in 2007. By mid-summer 2007, the Fed began lowering interest rates when banks throughout the world were experiencing serious default problems in recently created sub-prime housing loans. Fed Chairman Ben Bernanke led the chorus of those claiming "subprime is contained" while the Fed pushed short-term interest rates down from 5.25% nearly to zero.

During the panic of September and October of 2008 when it was feared that many, if not all, banks could fail due to losses on real estate loans, the Treasury and Fed cooked up a host of bailout programs such as the Troubled Asset Relief Program (TARP), Term Auction Loan Facility (TALF) and others known by acronyms such as PPIP, FSP, TGLP, CAP, TIP, CPFF, AMLF, MMIFF, etc.

The stock market fell nearly 50% from July 2007 to October 2008, while the economy was experiencing its sharpest downturn in nearly 30 years. In November 2008 the Bernanke Fed embarked on its first quantitative easing program ("QE1"). Beginning with an initial commitment of $600 billion, the Fed eventually purchased an unprecedented $1.75 trillion of mortgage backed securities and Treasury bonds.

With QE1 set to terminate on March 31, 2010, there was concern about what "exit strategy" the Fed would employ. A true exit strategy from QE would be not only the cessation of buying mortgage-backed securities and Treasury debt but also the sale of the Fed's debt holdings to banks. That would take money out of the economy thereby restricting economic activity.

Even though bonds were not sold back to banks, the U.S. economy in spring 2010 proved unprepared for even the cessation of more bond purchases by the Fed. Within weeks of the close of QE1 the S&P 500 began a turbulent two-month decline of 17% that was calmed only when the Bernanke Fed rode to the rescue, announcing more easing in which the proceeds of maturing bonds purchased in QE1 would be reinvested into like securities. This meant another $30 billion or so per month was recycled into the bond market.

Despite this extra stimulus, the stock market and economy continued to falter. So in a speech on August 27, 2010, Bernanke left little doubt that should the economy fail to improve quickly, the Fed would provide more economic stimulus. This gave financial market operators a green light for further speculation, because the Fed had all but promised to arrest any market decline by further "easing."

The Fed's actions appeared to have depressed bond interest rates while courting the risk of higher inflation. Consequently, in the financial markets there was a shift away from fixed income holdings and into stocks, many of which offered higher dividend yields than the interest rates on safe bonds. By November 3, 2010, when the Fed announced QE2 (an intention to make additional purchases of Treasury bonds totaling $600 billion), the market was already in a Fed-induced rally.

In an Op-Ed article published in The Washington Post on November 4, 2010, Bernanke made explicit the Fed's intention to elevate stock market prices: "Stock prices rose and long-term interest rates fell when investors began to anticipate the most recent action. Easier financial conditions ***will*** promote

economic growth. For example, lower mortgage rates ***will*** make housing more affordable and allow more homeowners to refinance. Lower corporate bond rates ***will*** encourage investment. And higher stock prices ***will*** boost consumer wealth and help increase confidence, which can also spur spending. Increased spending ***will*** lead to higher incomes and profits that, in a virtuous circle, ***will*** further support economic expansion."[1] [Emphasis added]

Bernanke's repeated use of the word "will" expresses a certainty that is novel – and inappropriate – to the fields of finance and economics. Due to a myriad of influences, neither the weather nor the economy can be forecast with certainty.[2] When economists are most confident about their predictions, their forecasting at most describes "probable" future conditions.

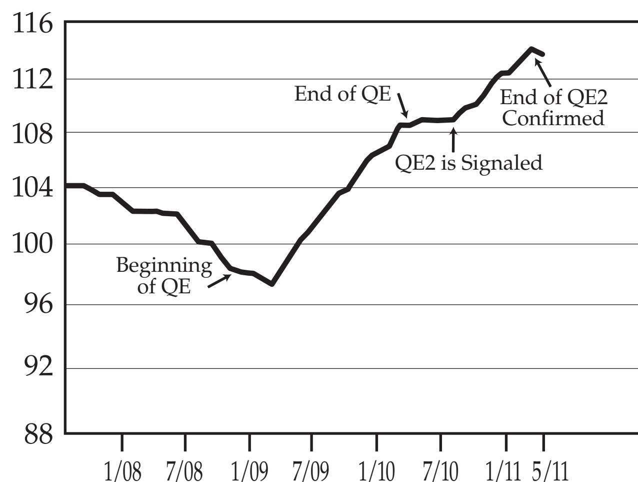
Contrary to what Bernanke expected, interest rates did not decline nor did demand for housing increase. QE2 brought higher stock market prices and increased spending by affluent Americans, but broad-based consumer spending increases failed to materialize. Perhaps this is because consumer prices rose, deterring most Americans from joining in Bernanke's predicted "virtuous circle [that] will further support economic expansion."

Now that QE2 has ended, the leading question being debated in the financial markets is: what might be next from the Fed? Unlike the spring of 2010, there is currently little talk of a Fed "exit strategy" and much disappointment from stock market participants that QE is over.

The accompanying graph shows the impact QE has had on the U.S. economy as measured by the Conference Board's Leading Economic Index, a widely respected indicator of economic activity.[3] Economic activity picks up while QE is in full swing. When QE is abandoned, economic activity slows.

In the last few months as the end of QE2 neared – yet while it was still occurring – economic activity was in decline. Housing remains in the doldrums, which makes banks reluctant to lend, and numerous other economic headwinds remain. Hopeful predictions of a "V-shaped" recovery are a faded memory replaced by the less inspiring "L-shaped" progression. Market participants know that the U.S.

QE or Not QE?
This Might be the Answer



The Conference Board Leading Economic Index (LEI) for the United States

Source: Conference Board

economy is still reliant upon stimulus. Without it, financial markets could decline in much the same manner when stimulus was previously withdrawn.

The "misery index" of the late 1970s has been resurrected. Combining the current rate of unemployment with the increase in the inflation rate as measured by the Consumer Price Index, today's misery index stands at 12.7% – the highest level since 1983.[4] During the era of "stagflation" – *i.e.,* high inflation with high unemployment – of the late 1970s and early 1980s, the "misery index" peaked at 22.0% in 1980. Using the same methods for calculating unemployment and price increases then in effect, applied to current government statistics, John Williams, the expert proprietor of the website Shadow Government Statistics, pegs the misery index at a staggering 33.5% as of the end of May 2011.[5]

Under these circumstances can Fed stimulus be finished? Unlike his first failed attempt at ending QE, Bernanke said in a press conference on April 27, 2011 that the Fed will from the outset continue to reinvest the enormous number of maturing securities it holds. To begin to sell the nearly $2 trillion worth of securities purchased by the Fed under QE would draw money out of the economy which easily could push the U.S. into recession.

The Fed faces a dilemma: whether to cease stimulating the economy and risk further economic downturn, or continue stimulating the economy and risk eventual high inflation.

While we cannot predict what the Fed will do, we note the opinion of legendary investor Jim Rogers, who says the Fed, as an institution, "has always been aware of election cycles and tries to make the economy good…I don't say that with admiration, I say that with scorn."

Given weak current economic underpinnings and a stock market looking to the Fed for continued support, we would not be surprised if a falling stock market brings the Bernanke Fed back to some form of easing. While it may go by a name other than "QE3," respected financial and market analyst Marc Faber recently observed, "[The stock market] may drop 10 to 15 percent. Then QE3 will come, then QE4, QE5, QE6, QE7 – whatever you want. The money printer will continue to print, that I'm sure."

With apologies to Lionel Richie's classic song "Easy," we hear the lyrics:

That's why I'm easy…
Easy like Ben Bernanke

MUNICIPAL BONDS: Sound investments – or not as good as they may appear?

With near-zero yields on cash and the wounds of the stock market crash of 2008 still not completely healed, the perceived safety and relatively high interest of municipal bonds ("munis") may appear attractive. But are muni bonds truly a sound investment or are they, rather, not as good as they may appear? Our evaluation is that, generally, munis have an adverse risk/reward ratio.

Historically, muni bonds have been considered among the safest fixed-income investments, with extremely low rates of default.[6] Generally, interest earned from muni bonds is exempt from federal income tax, and is also exempt from state income tax in the case of bonds issued by governmental entities of the state in which the investor resides.

A nominal yield around 4% is available on longer-term California munis, those maturing in 20 or more years. In a state with high income tax rates, such as California, for high tax-bracket investors, that 4% interest payment, exempt from federal and California income tax, results in the equivalent of around 7% interest on fully taxable corporate bonds. However, for California muni bonds with five-year maturities, currently the average yield to maturity is just over 1% for the highest credit quality, equivalent to 1.78% for fully taxable bonds of high credit quality.

The long-term safety of muni bonds is being called into question by a number of industry experts, such as Meredith Whitney who, long before the financial crisis of 2008, warned correctly that the biggest banks were in danger. In a TV interview in December 2010, Ms. Whitney predicted that the consequences of the current economic downturn will include "50 to 100 [or more] sizable [muni bond] defaults [amounting to] hundreds of billions of dollars," a view she has reiterated several times since.[7]

Declining revenues

To pay interest and principal on their bonds, state and local governments rely on revenue from income tax, sales tax, property tax, and excise tax. Revenue from these sources has fallen considerably since the Great Crash of 2008.

Underfunded state entitlement programs

There are many states with massively underfunded pension liabilities. A recent study put California's unfunded pension liabilities at around $500 billion.[8] Other states are even worse off; *e.g.,* the Illinois state pension system is underfunded by as much as 55%.[9]

Some states have under-funded long-term liabilities to employees for post-retirement health care. Medicaid obligations of the states for health care of low-income people are a large and increasingly burdensome expense and liability.

City/state budget gaps

Many states and cities are running huge budget gaps with expenditures that far exceed revenues, something that, unlike the federal government,

states and local governments cannot continue for long. While the budget problems in California, New Jersey and Wisconsin have been well publicized, many other states have similar serious financial problems. For example, Illinois, Nevada, and Massachusetts all have budget gaps exceeding 40%.[10]

Inflation risk

Inflation is the enemy of fixed-income investors, as the costs of goods and services increase over time, while the interest payments stay the same. Furthermore, at the maturity of a bond, the *nominal* principal is returned to the borrower, but the *purchasing power* of the principal is subject to erosion. *E.g.*, with inflation averaging 3½% per annum, the nominal principal of a ten-year bond would lose 29% of its original purchasing power by the maturity date.

Inflation is the consequence of an easy monetary policy, such as the Fed has so aggressively maintained over the last three years. Economists agree generally that the "easier" the policy of a Central Bank, such as the Fed, the higher the rate of inflation is likely to be.

Bond prices move inversely to interest rates – increasing as interest rates rise, and vice versa. For example, if a $25,000 bond of ten-year maturity is issued with a 5% interest rate and one year later bonds of comparable credit quality and maturity yield 6%, the market value of the original bond would have to fall to approximately $23,000 in order to yield 6% to maturity, as compensation for its below market nominal interest rate.

Bond interest rates are now near 40-year lows. Over the past four decades annual yields on 20-year general obligation municipal bonds have ranged from a low of 3.87% (October 2010) to a high of 13.28% (January 1982), averaging 6.40%.[11] Recently, the nominal annual yield on 20-year general obligation municipal bonds was 4.59%, or less than three quarters of one percent higher than the low of the last forty-one years. This historical range implies that going forward higher yields for bonds are more probable than unchanging or falling yields. Should bond yields rise, bond prices would fall correspondingly.

Although no one knows where bond interest rates are headed in the future, the deterioration of federal and state finances – even absent any defaults – implies that eventually investors will require higher yields to justify risking capital in bonds; and higher yields mean lower prices for all but the very shortest-term and highest quality bonds.

An expert's concern

Jeffrey Gundlach, a highly esteemed bond investor, says muni bonds are "badly owned" since they are held not based on their fundamentals but due to their tax status. He observes: "The fundamentals are going to look scary and I have a hard time thinking that the prices are going to hold up…It might not matter how many municipalities default," Gundlach continues, "They can return 98 cents on the dollar when all is said and done." However, "between here and the end game lies the valley. And the valley is full of fear. I think the muni market is going to go down by at least, on the long end, something like 15 to 20 percent…

"It gets scary when the prices start to drop. The fear factor here is going to be palpable. People

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 6/30/11.

	1-year	3-year	5-year	10-year
CVM Balanced Portfolio Composite	9.68%	4.94%	5.36%	4.63%
S&P 500 Index	30.48%	3.28%	2.89%	2.69%

who own munis tend to own them for the tax benefit and they tend to own most of their assets, if not all of their assets, in the muni asset class. So when they start to fall, they get nervous."

What of muni bond holders who say they will hold their bonds until maturity? They will hold them, Gundlach opines, "…until they get scared and sell."[12]

CREDITS

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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 June 30, 2011 we reduced our position in **Leucadia National** and eliminated our positions in **Bristol-Myers Squibb**, **Eli Lilly**, and **Stryker**. We increased our **Microsoft** holding and initiated positions in short-term bonds of **RR Donnelley** and **Seagate Technology**. The accompanying table sets forth the holdings in our Composite as of June 30, 2011. The table on page 6 presents the performance of the Composite for time periods ended June 30, 2011.

Composite Portfolio Holdings as of June 30, 2011

Security	Pct. Assets
Market Vectors Gold Miners ETF	8.1
Newmont Mining	8.0
Federated Prudent Dollar Bear Fund	6.6
Berkshire Hathaway	6.5
Central Fund of Canada	4.8
Federated Prudent Bear Fund	4.6
Pfizer	4.2
Pan American Silver	3.3
Johnson & Johnson	3.3
Microsoft	3.1
Medtronic	2.3
Abbott Laboratories	2.3
Wal-Mart Stores	2.1
Leucadia National	1.7
RR Donnelley & Sons, 5.625% due 1/15/2012	1.4
ConocoPhillips	1.2
CVS/Caremark	1.2
Seagate Technology, 6.375% due 10/1/2011	1.2
Markel	1.0
Chevron	0.9
Berkshire Hathaway, 7.125% due 10/15/2023	0.9
Other	2.4
Cash Equivalents	28.9
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

Richard Fisher, quoted at the top of page 1, is the President of the Federal Reserve Bank of Dallas.

[1]''What the Fed Did and Why: Supporting the Recovery and Sustaining Price Stability,'' by Ben S. Bernanke, Op-Ed, *The Washington Post*, November 4, 2010.

[2]See Gleick, James, *Chaos: Making a New Science* (1987)

[3]According to the Conference Board, its ''...composite economic indexes are the key elements in an analytic system designed to signal peaks and troughs in the business cycle.'' www.conference-board-org

[4]In 1983, interest rates were still elevated and inflation had declined significantly from its peak. This afforded the Fed the ability to usher in lower interest rates to spur economic activity. As discussed, today's Fed possesses no such luxury.

[5]See http://www.shadowstats.com/alternate_data/download_emp?mode=text and http://www.shadowstats.com/alternate_data/download_cpi?mode=text

[6]See the U.S. Municipal Bond Fairness Act of 2008 (HR 6308) DOCID: F:HR835.110.

[7]See *60 Minutes*, December 19, 2010, CBS.

[8]''Analysis of California Pensions Finds Half-Trillion-Dollar Gap,'' by Mary Williams Walsh, *New York Times*, April 6, 2010.

[9]See ''Illinois Pension Crises Eludes Easy Solutions'' by Michael Corkery, Op-Ed, *The Wall Street Journal*, March 16, 2011.

[10]See ''The Worst 2011 State Budget Gaps.'' www.cnbc.com.

[11]See the Bond Buyer GO-20 Municipal Bond Index of the Board of Governors of the U.S. Federal Reserve System. www.federalreserve.gov.

[12]Interview, Jeffrey Gundlach, March 9, 2011, http://www.cnbc.com/id/41986901/

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