

INVESTMENT VALUES

Issue Number 96, October 2010

*“Insanity is doing the same thing over and over again and expecting different results.”
– Albert Einstein*

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*CVM Balanced Portfolio Composite returns are net of transaction costs and investment advisory fees; S&P 500 returns include dividends. See pages 10 and 11 for information about the construction and performance of the Composite.

CURRENT OUTLOOK

CVM and the stock market

March of 2000 marked the end of a secular (long-term) bull market that started in August 1982 and the onset of a secular and ongoing bear market. The accompanying table shows how our clients generally fared over the ten years ended September 30, 2010 in comparison to the stock market, as represented by the S&P 500. Past performance is no guarantee, or even necessarily an indicator, of future results. Nevertheless, ten years is a reasonable test of investment performance in comparison to the S&P 500, the most widely used benchmark for stock market performance.

CVM Balanced Portfolio Composite vs. S&P 500 Ten Years Ended September 30, 2010

	Total Return*	Annual- ized Rate*
<i>CVM Balanced Portfolio Composite</i>	+72.93%	+5.63%
<i>S&P 500</i>	-4.41%	-0.45%

The perennial task of the value investor is to protect principal and invest profitably during times of adversity as well as good times. Today we invest in a time of adversity. Unemployment is persistently high; prices in the real estate market have been falling for four years; significant numbers of once profitable enterprises have gone out of business; the stock market is no higher than a dozen years ago; interest rates paid to savers on cash equivalents are near zero; and Government efforts to stimulate the economy have been to no avail. However, since August, the stock market has risen on the assumption that the Federal Reserve (the “Fed”) will resume its efforts to stimulate the economy and the financial markets.

Genesis of our “Great Recession”

Errors by the Fed are the fundamental cause of our current economic troubles, which are being called “The Great Recession” to distinguish this latest economic downturn from all others since the end of World War II. After 1989 the Fed repeatedly created too much money, and made credit too easy by lowering interest rates excessively in attempts to forestall any economic downturn. These policies stimulated successive booms and busts, first in the stock market of the late 1990s, and then in the 2000s when the Fed held interest rates too low for too long, fueling the unsustainable housing

boom in the real estate market and in asset-backed debt including, but not limited to mortgage-backed securities.

Recovery from an economic recession requires a period of adjustment which can be painful but short-lived. Or, government policies intended to minimize the pain of economic readjustment can prolong the readjustment, sometimes for years or even decades.

Real Estate

Residential housing prices are down 30% over the past four years, with no end of the decline in sight. "Eight million home loans are in some state of delinquency, default or foreclosure...and another eight million homeowners are estimated to have mortgages representing 95% or more of the value of their homes...leaving them with 5% or less equity in their homes and thus vulnerable to further price declines...[T]he foreclosure pipeline remains clogged [but] as it unclogs a new wave of homes will wash into the market and precipitate additional downward pressure on prices."¹ [Notes appear on page 12.]

The history of past recessions indicates that as long as the housing market and consumer spending remain in a slump, there can be no sustained economic recovery. A recovery in real estate is not yet in sight as the market is saturated with houses in or nearing foreclosure and homeowners suffer from \$771 billion in negative equity.²

Small business and the jobless recovery

According to the National Bureau of Economic Research, the recession started in November 2007 and ended in June 2009 with the beginning of economic recovery. However, it is a recovery without new jobs, as there has been net loss of 339,000 non-farm jobs since June 2009.³

U.S. Census Bureau data show that new companies account for all net job creation, having generated more than 3 million new positions each year since the 1970s, whereas existing firms have lost one million on average. Payroll taxes and employee benefits typically amount to one-third of

a business' cost of an employee. Indirect costs such as compliance with regulations add much more.⁴

In every recession over the last three decades, it has been America's small businesses that led recovery by creating new jobs. That is not happening now as several factors are restraining small-business owners from hiring, including near-stagnant demand for goods and services as a result of consumers' reluctance to return to their free-spending ways; a falloff in the creation of new small businesses; the devastation of the real estate market; and uncertainty about the economic outlook, including fears of more regulations, taxes and government-mandated costs under new healthcare rules and pending legislation on energy.⁵

At present, bank loans are virtually unavailable for the startup or expansion of a small business. Home equity loans and credit cards have been a traditional source of funding for small business, but because banks are over-loaded with non-performing loans (especially on real estate) they have greatly reduced credit card limits and are making few home equity loans.

Larger businesses have a record \$1.8 trillion in cash and equivalents on hand, and banks have nearly \$1 trillion in reserves that can be used to back up a large multiple of that amount in loans. However, banks are reluctant to take the risk of business lending due to being already over-loaded with non-performing loans; and larger businesses have stopped investing, expanding, and hiring not because they don't have cash (they do), in part because of uncertainty about the legal and tax environment,⁶ but mainly because of economic conditions and concern that there could be a renewed downturn in the economy.

QUANTITATIVE EASING: REFLATION

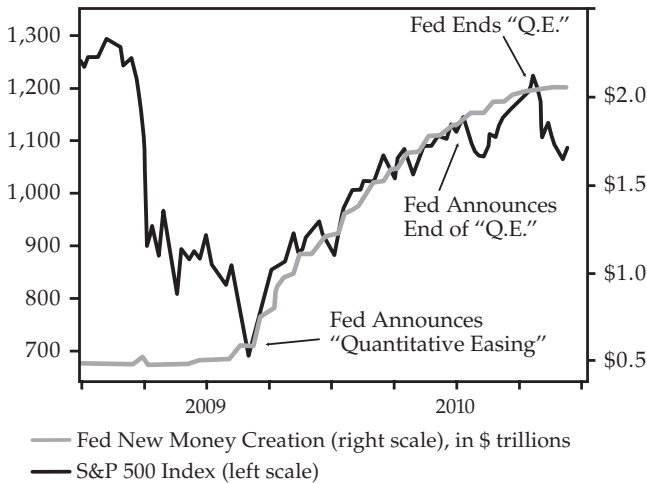
Cutting interest rates is the standard method employed by the Fed to combat economic downturns. "Easing" has been the term for an "easy money" policy to stimulate economic activity, implemented usually by low interest rates.

The Fed reduced its short-term interest rates to near zero in the fall of 2008. However, this left no

room for the Fed to cut interest rates further as the Great Recession and falling asset prices continued. So early last year the Fed decided to stimulate the economy by creating a flood of money virtually out of thin air, through a process it calls “quantitative easing” (QE).

The term “quantitative” means that if ultra-low interest rates were not enough to stimulate lending and borrowing, the Fed would inject newly created money, around \$1.7 trillion at last count, into the financial system, as a form of financial force feeding. Mostly this took the form of buying mortgage-backed securities to support the residential real estate market, but the Fed used some of its newly created money to buy U.S. Treasury debt. *I.e.*, while one arm of the government issued debt, another arm bought the debt with manufactured money of its own creation. From a monetary perspective, that is pure inflation.

Fed Money Creation and the S&P 500 Index January 2009 through June 2010



Source: James Turk

The accompanying graph illustrates the impact that quantitative easing seems to have had on the stock market – namely a little more than 50% rise in the S&P 500 from the start to the end of QE last March. The Fed didn’t want to continue QE too far or too long out of concern for possible consequent high price inflation and potential backlash from large foreign holders of our federal debt, so it ended earlier this year. Perhaps not coincidentally, since the end of QE on March 31, 2010 the stock

market rise stalled, and the S&P is no higher now than at the time the Fed ceased QE last March 31.

The Fed said recently that if the economy does not perk up it would reinstitute “accommodation.”⁷ Accommodation and quantitative easing are code words for reflation – the deliberate inflation of the money supply to stimulate a deflating economy. Reflation has been tried again and again, always without success.

Writing in 1896, historian and economist William Graham Sumner observed:

“For three hundred years our history has been marked by the alternations of ‘prosperity’ and ‘distress’ which are produced by the booms and their collapses. When the collapse comes, the people who are left long on goods and land always make a great outcry and start a political agitation. Their favorite device always is to try to inflate the currency and raise prices again until they can unload...No scheme which has ever been devised by them has ever made a collapsed boom go up again. The most far-reaching vice in all these schemes was that they led the people to believe that the methods of a ‘boom’ could be successfully employed in the place of the methods of thrift.”⁸

There is cause for concern that a Fed policy of reflation will lead to eventual high inflation. Under its current chairman Ben Bernanke, Fed policy is designed to combat *deflation* because of fear it would be accompanied by an economic depression like that of the 1930s. In 2002 Mr. Bernanke said that the Fed could and should create *inflation* as a means of preventing *deflation*.⁹ In 2003, the Fed brought about negative real interest rates – short-term rates lower than the rate of price inflation – that led to the housing bubble that, in turn, brought on the Great Recession of 2007-09.

Deflation (as measured by falling prices) occurred in the Great Depression of the 1930s because as incomes declined, spending declined, forcing prices down, with the Consumer Price Index (CPI) falling nearly 20% from 1929 to 1939. Today, the Fed under Chairman Bernanke operates on the premise that price deflation and depression are inexorably linked, so price deflation must be halted to avert a depression.

However, deflation (as measured by falling prices) also occurred in the U.S. over the 50-year period 1864 to 1914, a time of generally rising prosperity, when increasing productivity caused prices to fall relative to incomes.¹⁰ Economic history shows that there are more periods of price deflation with reasonable growth and prosperity than with depression, and many more periods of depression with inflation than with deflation.¹¹

It appears that the Great Recession is in large part a product of prior deliberate inflationary policies of the Fed over the past 20 years, and that reflation will exacerbate, not mitigate the problems of the American economy by devaluing the U.S. dollar. A devalued dollar would eventually force the U.S. to pay much higher interest on its rapidly mounting debt, will increase the cost of goods in the U.S., and could lower the overall American standard of living.

WHY STIMULUS FAILED TO STIMULATE: *Lessons not learned*

The idea behind government stimulus spending is that an economic downturn is caused by insufficient spending by consumers and businesses. Therefore, the government ought to encourage more consumption and business investment by means of government programs. For example, the 2008 and 2009 federal stimulus programs provided cash payments to low- and middle-income taxpayers and incentives to stimulate personal consumption, business investment and home loans.

The “cash for clunkers” spending and the first-time home buyer’s tax credit are two such incentives. However, they had no lasting effect because they only pulled potential purchases of cars or homes forward by a few months. A large part of the 2009 federal stimulus program was payments to state and local governments to enable them to pay current public employee salaries, a temporary subsidy that did not address the long-term financial problems of state and local government.

These programs have failed to spur an economic recovery. Current economic activity is sluggish and unemployment remains high. Yet

there is a call in the federal government for still more stimulus spending.

These programs have not worked because, as shown by experience, in a severe economic downturn households generally will reduce consumption and increase savings out of concern for their financial future, just as corporations are now doing. The more that governments spend to stimulate private spending, the more households save and pay down debt, perhaps because they sense that they will have to pay for government’s deficit spending by future taxes or the implicit tax of higher inflation.¹²

History shows that government spending to stimulate private spending in a recession does not work. A study of 21 large countries over the period 1970-2007 shows that government spending increases meant to stimulate the economy failed to achieve their goals.¹³

During the Great Depression of the 1930s deficit spending by the U.S. government, undertaken in large part to stimulate consumer spending, tripled the national debt in real (inflation-adjusted) terms, without ending the depression.

Japan has been trying stimulus without success during most of its nearly 20-year economic recession. In the late 1980s the Japanese stock and real estate markets experienced one of the greatest bubbles in world history. At its 1989 peak “Japan’s property market was reckoned by sober people [in the Japanese government] to be worth over... four times the estimated value of American property [even though] America is twenty-five times bigger than Japan.”¹⁴ At the same time, in terms of price/earnings ratios, the Japanese stock market was priced at around five times the worth of the American stock market.

The Japanese economy has been in recession ever since 1990 with Japanese real estate and stocks still down over 75% from their 1989 peak. Throughout this time the Japanese government has been profligate in its use of stimulus via government spending and ultra-low interest rates. Yet the economic slump actually worsened as time passed.¹⁵

A Bank of Japan study of Japan’s experience with Quantitative Easing Policy (QEP) from 2001 to 2006 showed that it had little effect in stimulating

spending and higher asset prices.¹⁶ Nevertheless, as we write, the Japanese government is continuing to try still more economic stimulus, keeping the central bank's key interest rate at 0.1% and undertaking to expand a low-interest loan program to financial institutions.¹⁷

Over the past 20 years the leaders of the Fed believed, mistakenly, that bubbles could not be identified, so the Fed should do nothing to inhibit the formation of a bubble but should confine its activity to cleaning up the aftermath. This policy has been proven to be totally flawed, as demonstrated convincingly in two recent books.¹⁸

THE CASE FOR PRECIOUS METALS

Gold and silver rose in the 1970s on increasing fears that inflation in the U.S. dollar was getting out of hand, with the CPI up 13.3% in 1979 and up over 100% from 1970 to 1980. However, starting late in 1979, the Fed under then-Chairman Paul Volcker initiated a successful new policy to curb the supply of money and thereby restrain inflation. Volcker's policies reduced inflation fears and thereby effectively ended the gold and silver bubbles. By the latter part of 1981 the price of gold had been cut in half, and by 1985-1987 inflation had fallen to an average of 3.1%.

Today, with gold and silver prices up around 400% over the past decade, it is again fear of monetary inflation that is driving up these prices in relation to all paper monies, including the U.S. dollar (USD). Some financial commentators are warning that gold is in a bubble. There is historical precedent for that idea.

For nearly 20 years after 1981, gold and silver prices languished after rising to all-time highs in the 1970s with a bubble-like climax in 1979-1980. However, in our view comments about a gold bubble fail to take into account some factors, discussed below, that we believe have the potential to drive gold prices far higher than today.

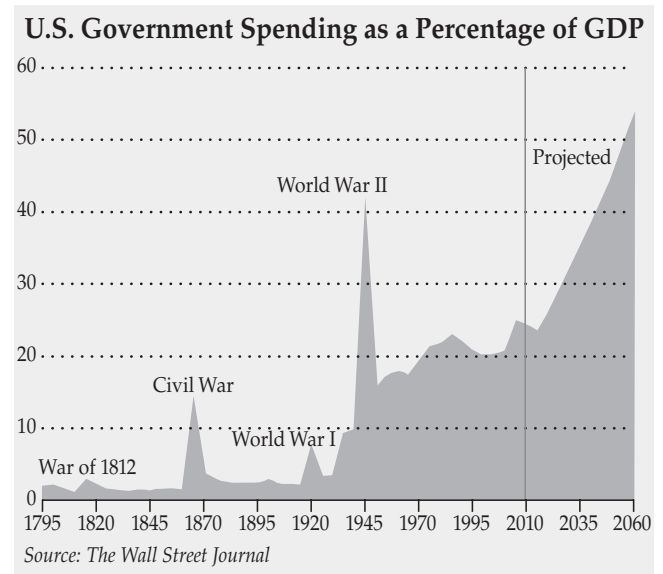
Precious metals, especially gold, have been used as money for over 2,500 years because they have been a reliable store of value. Today, every nation in the world issues fiat money. The word "fiat," medieval Latin for "let it be done," signifies a

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. Currency such as the paper money we all carry and fixed claims (bank deposits, bonds, etc.) payable in a nation's money are all forms of fiat money.

With its Quantitative Easing initiative the Fed has been trying deliberately to create inflation, as Fed Chairman Bernanke promised to do in a speech he gave in 2002, when he said "...the U.S. government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost."¹⁹

Large government budget deficits go hand in hand with monetary inflation in the U.S. and every other country. As our national debt has gone from \$1.1 billion in 1910 to nearly \$12 trillion (\$12,000 billion) a year ago, a compound annualized increase of 9.74%, the USD has lost 95% of its purchasing power in terms of the CPI.²⁰

The federal Office of Management and Budget (OMB) projects \$8.4 trillion of deficit spending over the next ten years. This could be too optimistic. Ten years ago the OMB projection said that 2010 would be a year of prosperity and government budget surplus.²¹ The accompanying graph shows that U.S. Government spending as a percentage of GDP is now higher than at any time since World War II, and is projected to go still higher.



The Congressional Budget Office (CBO) recently published a report entitled “Federal Debt and the Risk of a Fiscal Crisis.”²² The following statements appear in the CBO’s Summary of this report.

“Unless policymakers restrain the growth of spending, increase revenues significantly as a share of GDP, or adopt some combination of those two approaches, growing budget deficits will cause debt to rise to unsupportable levels...

“[P]ersistent deficits and continually mounting debt would have several negative economic consequences for the United States... [A] growing level of federal debt would... increase the probability of a sudden fiscal crisis, during which investors would lose confidence in the government’s ability to manage its budget, and the government would thereby lose its ability to borrow at affordable rates...

“[A]s other countries’ experiences show, it is also possible that investors would lose confidence abruptly and interest rates on government debt would rise sharply... **If the United States encountered a fiscal crisis, the abrupt rise in interest rates would reflect investors’ fears that the government would renege on the terms of its existing debt or that it would increase the supply of money to finance its activities or pay creditors and thereby boost inflation.**” [Emphasis added]

The Fed’s reflation policy with its incessant cheapening of the U.S. dollar is causing growing loss of confidence in the dollar, which recently has been falling against other major currencies.²³ For example, China, which holds 21% of U.S. Treasury debt, is growing uneasy about loss in the value of its dollar holdings. Yu Yongding, a former adviser to China’s central bank, said recently, “*I do not think U.S. Treasuries are safe in the medium and long-run but China is unable to sell Treasuries in a big way; and U.S. budget deficits are on a scary trajectory.*” This Chinese banker also opined that rising U.S. debt to other nations was bringing the U.S. dollar nearer to a crisis.²⁴ China’s ambassador to the World Trade Organization, Sun Zhenyu, said recently that “We are very much concerned about how the U.S. would take practical and responsible measures to prevent the dollar glut and maintain the stability of the currency.”²⁵

Global loss of confidence in the dollar could cause massive dumping of the dollar and U.S. Treasury securities and a severe decline in the relative value of the dollar. Then the Fed will get high inflation until it follows the lead of former Fed Chairman Paul Volcker in 1979, and raises interest rates high enough to protect the value of the dollar.

Although the U.S. dollar is the currency used for much of the trade in gold, it is global demand that drives the price of gold. Central banks of developed countries are moving to devalue their national monies by inflation, to restrain their currencies from rising against those of international trading partners; that is contributing to the recent rise in gold prices.²⁶ The dollar value of the global supply of fixed claims (cash, cash equivalents, and bonds of public and private entities) is approximately ten times as large as the dollar value of gold at current prices. Therefore, any further significant movement out of claims fixed in fiat money valuation could lead to acceleration in the rise of the price of gold as well as silver.

We have sought to protect the real value of our clients’ assets from loss of purchasing power in the dollar by our holdings in equities and, in the last five years by our commitment to precious metals related securities which are now a significant portion of the value of our clients’ assets. This emphasis on precious metals has contributed importantly to the positive ten-year returns in our client Composite, shown on page 1.

BONDS vs. STOCKS FOR INCOME AND SAFETY

Currently dividend-paying shares of an adequate number of companies not only pay dividends at a higher rate than bond interest, but also appear to offer greater long-term safety of capital than the safest bonds.

The Investment Company Institute reported recently that from January 2008 through June 2010, *outflows* from equity (stock market) mutual funds totaled \$232 billion while bond mutual funds have had a \$559 billion *inflow* of cash.²⁷ No doubt these cash flows out of stocks and into bonds are a

response to the pain mutual fund investors have experienced in the stock market over the past decade, in which most individuals have lost money in the stock market, as represented by the S&P and the average returns on diversified equity mutual funds.

The low interest rate on cash equivalents is another reason for the present popularity of bonds. The current annual interest rate on fixed dollar investments is less than 0.1% on money market mutual funds, less than 0.25% on U.S. Treasury bills (government obligations maturing in one year or less), and less than 0.5% on demand deposits with banks.

The increased buying of bonds has pushed bond prices up and has thereby reduced interest rates on investment grade bonds to the lowest level in over 50 years: less than 1% per annum on maturities of two or three years (Microsoft having just sold 3-year maturity bonds yielding 0.875%), less than 1.5% per annum on five-year maturities, less than 3% on the 10-year Treasury Note, and around 4% on the highest credit quality 10-year corporate bonds.

In comparison, there is an attractive dividend yield available on shares of large, prominent, and conservatively-financed companies that are going through a period of relative unpopularity. Recently we searched the stock market for companies with a current yield of 3.0% or better, above average financial strength, a business with the proven ability to cope with adversity, and a long record of continuous dividend payments.

We found 46 companies that met all these requirements.²⁸ The group is diversified among 22 different industries. The average yield on the list was 3.9% as of last month. On average, these companies have been paying dividends continuously for 61 years. Twenty of the companies have raised their dividend every year for at least the past ten years.

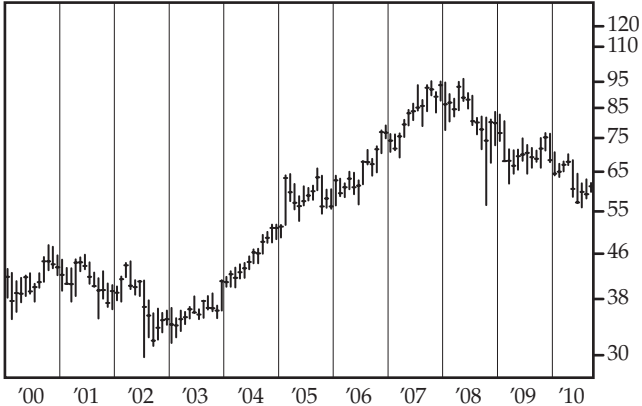
The companies are currently paying out on average 60% of net profits as cash dividends to shareholders, allowing for reinvestment of the remaining 40% of profits in their businesses. This is the reason that shares of such companies typically outperform bonds over time: businesses

retain earnings, with those retained earnings going on to generate still more earnings and rising dividends as well.

Of course, share price declines can more than offset dividend income over an investor's holding period. For example, in the S&P 500 over the ten years ended September 30, 2010 capital depreciation of 20.6% more than offset the income return from dividends, resulting in a *negative total return* of 4.1% for the ten years.

We examined the share price changes of our 46-company group of dividend payers. Over the past decade the average change in share price for the group was *plus 45%*. The accompanying graph of the share price of ExxonMobil (XOM) over the past decade is presented as an illustration of the approximate aggregate share price performance of our 46-company list.²⁹

**Exxon Mobil Corp (XOM)
Share Price Change 2000-2010**



Source: Securities Research Company

Although XOM shares usually have relatively low volatility compared to the overall market, the XOM graph illustrates the potential market price volatility in common stocks. Investors in common stocks must expect and be able to cope emotionally and financially with the possibility, and even the probability that over a period of several years shares of any company they own may fluctuate as much as 100% above and 50% below their median price. However, with a well-diversified portfolio of sensibly priced common stocks, the aggregate fluctuation should be significantly less than for individual companies.

Past performance is no guarantee, nor even necessarily an indication of future performance. Thus, there can be no assurance from the record of the *past* ten years that our list of companies or any similarly constructed list of companies will experience aggregate share price gains over the next ten years, or over any future period.

Nevertheless, it is noteworthy that this group of 46 companies experienced an average capital gain of 45% over the past decade while the overall market, as represented by the S&P 500, experienced a capital loss of 20%. The explanation for this difference is to be found in the euphoric atmosphere of a bull market climax ten years ago, when the overall market was extremely over-priced and dividend-paying stocks were out of favor because dividends were widely considered to be of little consequence compared to capital gains.

The dean of value investing, Benjamin Graham (1894-1976), would not have been surprised by the rush of market participants into over-priced bonds today or their rush into over-priced stocks a decade and more ago. To help investors guard against such impulsive and irrational commitments was part of the motivation for his creation of the discipline of value investing. To epitomize his approach, he placed opposite the title page of his first great book, *Security Analysis*, the following quotation from the Roman poet Horace: "*Many shall be restored that now are fallen and many shall fall that now are in honor.*"

The essential point now is not that dividend-paying stocks are priced at bargain prices today in comparison to historical parameters of stock market valuation, but rather that bonds currently are a poor investment relative to shares of well-established, stable, companies with a dividend rate higher than the interest rate on investment-grade bonds.

Investment grade bond yields are at 50-year lows. Consequently, major corporations, such as Home Depot, IBM, Johnson & Johnson, McDonald's, Microsoft, and others recently have issued bonds paying interest at rates lower than the current dividend rate on their shares, while stating they may use some of the money from bond sales to buy back their own shares. Such

companies don't need to sell bonds to fund their operations, as profit and cash flow from their businesses is more than adequate for all their needs.

If high quality companies that have no need for cash are issuing bonds to raise cash, should individuals pause to ask themselves why this is so before buying bonds or bond mutual funds? Who is in a better position to determine the relative value of stocks and bonds today – market participants who are selling stocks and buying bonds or the companies that are selling bonds and buying back their shares? Stating the question suggests the self-evident answer, and also brings to mind the following comment by master investor Warren Buffett: "*If you've been playing poker for half an hour and you still don't know who the patsy is, you're the patsy.*"

Even celebrated bond manager Bill Gross has been saying that stocks may be preferable to bonds at current relative valuations.³⁰ Gross' firm, PIMCO, has always managed only bond funds. However, PIMCO recently created stock funds in recognition that bonds are currently over-priced relative to stocks.

Bond returns have been low to negative, and lower than stock market returns when starting from a point of historically low bond yields, such as those of today. For example, bond interest was low in 1950. Subsequently, long-term Treasury bonds provided negative real (inflation-adjusted) total returns, and returns lower than the stock market over the five, ten, twenty and thirty year periods starting in 1950.³¹

The low interest rates of the 1950s were followed by high inflation in the 1960s and 1970s – an inflation that badly eroded the real value of longer-term bonds. If that situation were to recur, as we are concerned that it may, intelligent investing in dividend-paying common stocks can provide better protection of capital than bonds.

The accompanying table sets forth the comparative real (inflation-adjusted) returns of U.S. Treasury Bills (T-Bills), U.S. Treasury Bonds (T-Bonds), and the Standard & Poor's 500 Index (S&P) for periods of five, ten, twenty and thirty years beginning in 1950. The data for this table is as follows. CPI: The U.S. Consumer Price Index for All Urban Consumers. T-bills: U.S. Government

**COMPARATIVE REAL ANNUALIZED RATES OF RETURN:
Treasury Bills, Treasury Bonds, S&P 500
Periods beginning January 1950**

	CPI	T-Bills	T-Bonds	S&P
5 years (1950-54)	2.5%	- 1.1%	- 0.9%	15.8%
10 years (1950-59)	2.2%	- 0.3%	- 0.1%	17.2%
20 years (1950-69)	2.4%	+ 0.5%	- 1.2%	11.0%
30 years (1950-79)	4.0%	0.0%	- 1.7%	6.9%

obligations maturing in not more than one year. T-bonds: U.S. Government obligations with an average maturity of 20 years. S&P: the total return including price change plus reinvested dividends. The S&P represents about 75% of the total market value of all publicly traded shares of U.S. companies and is the most widely used benchmark of stock market performance. The data is taken from *Ibbotson SBBI 2010 Classic Yearbook: Market Results for Stocks, Bonds, Bills, and Inflation 1926-2009* and from Standard & Poor's, <http://www.standardandpoors.com/home/en/us>

In 1980 bond interest rates were high (11% for long-term Treasury bonds) and the CPI inflation rate was high too – at 12.4% for the year. Subsequently, as inflation fell, bonds did well relative to inflation over the five, ten, twenty and thirty years beginning in 1980, with real returns ranging from a low of 3.3% (1980-84) to a high of 7.5% (1980-1989). However, the S&P 500 did even better over the five, ten, twenty and thirty year periods beginning in 1980, with real returns ranging from a low of 7.7% (1980-2009) to a high of 13.9% (1980-1999).

All performance comparisons are extremely time sensitive. *I.e.*, a change in the start or end date can make a big difference. Thus, for the ten years beginning in 2000, bonds did far better than the S&P. That is because at the beginning of 2000 the S&P was just ending a secular bull market of nearly eighteen years duration that took the S&P to its most over-valued level ever, with a dividend yield of barely 1%.

Dividend yield is the product of annualized cash dividends divided by share price. In the

30-year period beginning in 1980, dividends rose substantially, but share prices soared far higher. Consequently, the dividend yield on the S&P went from nearly 7% at the beginning of 1980 to 3.5% at the beginning of 1990 and then to barely 1% at the beginning of 2000. That low 1% yield on the S&P was one of several factors indicating extreme over-valuation and high risk in the stock market at the beginning of 2000. At that time, stock market participants chased ever-higher stock prices by increasing their holdings of stocks and equity mutual funds just when they presented ever-decreasing value. That is why so many people suffered large stock market losses after 1999.

Similarly, in our view, today the low yield on investment grade bonds is a principal factor indicating extreme over-valuation and high risk in the bond market at present. We are concerned that over time the large numbers of individuals and institutions currently piling into bonds and bond funds will be sorely disappointed.

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 September 30, 2010 we increased our holdings in **Johnson & Johnson (JNJ)**, **Medtronic (MDT)**, and **Microsoft (MSFT)** and eliminated our holdings in **UnitedHealth Group (UNH)**. We initiated an investment in **CVS Caremark Corporation (CVS)**.

CVS is the largest pharmacy company in the United States. In 2009 it had sales of \$98.7 and net income of \$3.8 billion. The company has a current stock market value of about \$40 billion.

CVS operates three businesses: CVS retail pharmacy, Caremark pharmacy services, and chronic disease management. Caremark’s pharmacy service business serves employers, insurance companies, unions, government employee groups, managed care organizations and other sponsors of health benefit plans. The Caremark business includes mail order and specialty pharmacy services, prescription drug benefit plan design and

administration, formulary management, claims processing and Medicare prescription drug plans.

The CVS retail pharmacy business has approximately 7,100 stores in 41 states and the District of Columbia and sells prescription drugs, over-the-counter medicines, and various consumer products and services at retail and online.

The company also offers a chronic disease management program for diseases such as asthma, diabetes, congestive heart failure, and coronary artery disease.

CVS has had above average growth in revenues, earnings, and dividends over the past decade. However, growth has slowed during the current economic recession and the share price is down one-third from its high of two years ago.

CVS pays a modest cash dividend (1.2% on current market price), but retains nearly 90% of its earnings, leaving ample room for future growth in the dividend.

New leadership at the Caremark pharmacy business is improving profitability within that business; the CVS retail base remains dominant; and the company should profit from a wave of patent expirations in the pharmaceutical industry over the next few years.

The recent market valuation of CVS shares is at a significant discount to those of its competitors in retail pharmacy and in pharmacy benefit management, despite the company’s major strengths, excellent finances and ability to buy back large quantities of its shares at attractive levels.

The table on page 11 sets forth the holdings in our Composite as of September 30, 2010.

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 9/30/10.

	<u>1-year</u>	<u>3-year</u>	<u>5-year</u>	<u>8-year</u>	<u>10-year</u>
CVM Balanced Portfolio Composite	11.76%	3.86%	5.48%	5.84%	5.63%
S&P 500 Index	10.13%	-7.18%	0.62%	6.37%	-0.45%

*Composite Portfolio Holdings
as of September 30, 2010*

Security	Pct. Assets
Market Vectors Gold Miners ETF	8.8
Newmont Mining	8.1
Berkshire Hathaway	7.7
Federated Prudent Dollar Bear Fund	6.1
Pan American Silver	5.5
Federated Prudent Bear Fund	5.4
Pfizer	4.4
Central Fund of Canada	4.2
Johnson & Johnson	2.9
Leucadia National	2.4
Abbott Laboratories	2.2
Wal-Mart Stores	2.1
Medtronic	2.1
Stryker	1.9
Microsoft	1.9
Bristol Myers-Squibb	1.6
Eli Lilly	1.5
Coca-Cola Enterprises	1.3
Markel	1.0
ConocoPhillips	1.0
Berkshire Hathaway, 7.125% due 10/15/2023	1.0
CVS/Caremark	1.0
Chevron	0.9
Verizon Communications	0.8
Other	3.6
Cash Equivalents	20.6
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

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- ²“Why We’re in for a Long, Hard Economic Slog,” by Steven Gjerstad and Vernon L. Smith, Op-Ed, *The Wall Street Journal*, Sept. 10, 2010.
- ³“Recession May Be Over, but Joblessness Remains,” by Catherine Rampell, *The New York Times*, Sept. 21, 2010.
- ⁴“Every Man (and Woman) an Entrepreneur,” by Tim Kane, *Forbes*, Sept. 13, 2010.
- ⁵“Small business sidelined in slow recovery from recession,” by Don Lee, *Los Angeles Times*, July 3, 2010. For anecdotal evidence to the same effect see “Why I’m Not Hiring,” by Michael P. Fleischer (owner of a company with 83 employees), Op-Ed, *The Wall Street Journal*, Aug. 9, 2010.
- ⁶See “Principles for Economic Revival,” by George P. Shultz, Michael J. Boskin, John F. Cogan, Allan Meltzer and John B. Taylor, Op-Ed, *The Wall Street Journal*, Sept. 16, 2010.
- ⁷See “Fed Hints at Move to Boost Recovery,” by J. Hilsenrath and L. Di Leo, *The Wall Street Journal*, Sept. 22, 2010.
- ⁸Quoted in “Reflation in American History,” by H. A. Scott Trask, Ludwig von Mises Institute, Oct. 31, 2003, <http://misis.org/daily/1363>
- ⁹“Deflation: Making Sure ‘It’ Doesn’t Happen Here,” Remarks by Fed Governor Ben S. Bernanke, Nov. 21, 2002, <http://www.federalreserve.gov/boarddocs/speeches/2002/20021121/default.htm>
- ¹⁰Shilling, A. Gary, *Deflation* (1998), chapter 21.
- ¹¹“Deflation Demystified,” by Gene Epstein, *Barron’s*, Aug. 30, 2010, citing “Deflation and Depression: Is There an Empirical Link?” by Andrew Atkeson and Patrick J. Kehoe, National Bureau of Economic Research, Feb. 2004, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=495773
- ¹²“Why a Deficit-Financed Stimulus Leads Nowhere but to Stagnation,” by Jerry L. Jordan (past president of the Federal Reserve Bank of Cleveland), *Investor’s Business Daily*, Op-Ed, Sept. 30, 2010.
- ¹³The study surveyed 21 member countries of the Organization for Economic Cooperation and Development (OECD). See “Tax Cuts vs. ‘Stimulus’: The Evidence is In,” by Alberto Alesina, Op-Ed, *The Wall Street Journal*, Sept. 15, 2010.
- ¹⁴Wood, Christopher, *The Bubble Economy: Japan’s Extraordinary Speculative Boom of the ‘80s and the Dramatic Bust of the ‘90s* (1993), page 50.
- ¹⁵*Two Lost Decades? Why Japan’s Economy Is Still Stumbling and How the U.S. Can Stay Upright*, by D. Scissors and J. D. Foster, Heritage Foundation, Feb. 23, 2009.
- ¹⁶“Effects of the Quantitative Easing Policy: A Survey of Empirical Analyses,” by Hiroshi Ugai, Chief Manager and Senior Economist, Policy Research Division, Policy Planning Office, Bank of Japan, July 2006, <http://www.boj.or.jp/en/type/ronbun/ron/wps/wp06e10.htm>
- ¹⁷See “Japan central bank eases policy as economy falters,” by Tomoko A. Hosaka, Associated Press, Aug. 30, 2010.
- ¹⁸*Greenspan’s Bubbles* (2008) by William A. Fleckenstein and *Wall Street Devalued* (2009) by Andrew Smithers.
- ¹⁹Quoted from Mr. Bernanke’s speech of November 2002, see note 9 above. <http://www.federalreserve.gov/boarddocs/speeches/2002/20021121/default.htm>
- ²⁰See the CPI Inflation Calculator published by the U.S. Bureau of Labor Statistics, at http://www.bls.gov/data/inflation_calculator.htm
- ²¹“Making a Better Start,” by Thomas G. Donlan, Editorial, *Barron’s*, Sept. 27, 2010.
- ²²Congressional Budget Office, July 27, 2010, <http://www.cbo.gov/doc.cfm?index=11659>
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- ²⁸Our clients’ accounts hold shares of eight of the 46 companies.
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- ³⁰Mr. Gross is in charge of the Pimco Total Return Fund, a bond fund with over \$200 billion in assets. See “Bill Gross Warning May Catch Bond-Fund Investors Off Guard,” by S. V. Bhaktavatsalam and C. Condon, *Business Week*, March 26, 2010.
- ³¹*Ibbotson S&P 500 Classic Yearbook: Market Results for Stocks, Bonds, Bills, and Inflation 1926-2009*, Appendix C, pages 229-271.

Contact information: 100 Wilshire Blvd., Suite 2020, Santa Monica, CA 90401; (310) 451-8600;
email: contact@cheviotvalue.com; web address: www.cheviotvalue.com.

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