CHEVIOT VALUE MANAGEMENT, LLC

INVESTMENT VALUES

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"The investor's chief problem – and even his worst enemy – is likely to be himself."
– Benjamin Graham

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This 100th issue of *Investment Values* coincides with the end of our 25th year of publication and 26 years of our firm providing investment counseling to clients. We are pleased to have in place Darren Pollock and David Horvitz as our second generation of value investors and financial counselors working on our clients' behalf.

AMERICA'S ECONOMIC HERITAGE

Over the first 130 years following liberation of America from the rule of British monarchy, the prosperity of the American people increased at a rate unprecedented in human history and the United States became the most powerful and influential country on earth.

After the devastation and tragedy of World War II, America was the only large industrialized country that emerged from the war with its productive capacity intact. That competitive advantage was a prime source of a renewed and widespread prosperity.

The trouble with an extended period of prosperity is that it begets complacency. Since 1960 America has indulged in a prolonged binge of unwise borrowing and spending at all levels of society: by individuals, families, businesses, and government. We are now suffering the consequences of those years of growing debt-financed consumption.

The three graphs on the following pages illustrate how we have created much of our current predicament. Graph one, "Entitlement Nation," shows the very large share of national resources that has gone to increase consumption rather than production, via federal government spending.

The second graph, "Not as Good as Gold," shows the negative impact of increased debt-financed consumption and reduced production on the value of the U.S. dollar relative to gold.

Graph 3 illustrates the decline of interest rates – a decline caused by policies of our central bank, the Federal Reserve ("the Fed") intended to stimulate people and businesses to resume borrowing and spending in the very ways that led to our financial crisis and economic recession. The recent unnaturally low interest rates punish thrift, saving, and investing, thereby creating disincentives to the activities that help to create prosperity.

As the decade of the 2000s opened, wise and experienced observers warned of danger ahead in the economy and the stock market.[1] [*Notes appear on page 8.*] However, the increase in debt-financed consumption continued in the decade of the 2000s, fueled by a real estate boom caused by low interest rates and lax lending standards. Real estate prices peaked then started down in 2006-2007 and our country entered the biggest downturn in real estate since the 1930s.

In an effort to stimulate renewed production and job creation the federal government is spending

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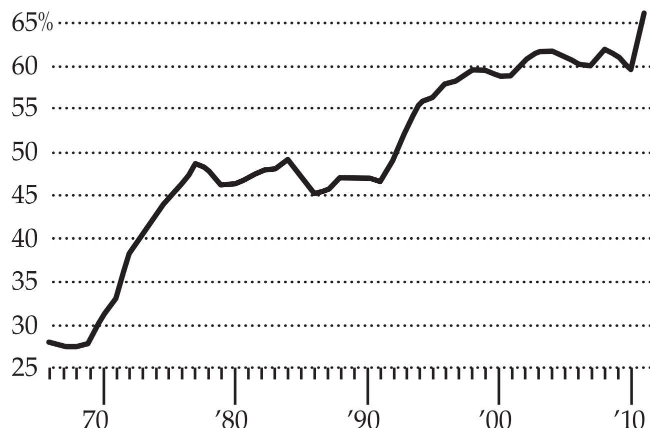
Entitlement Nation

Payments to individuals as a percentage of federal outlays, 1965-2010



Source: U.S. Office of Management and Budget

more, in real (inflation-adjusted) terms than it has ever spent before in peacetime. Economists differ on the efficacy and consequences of the spending, but it is not debatable that we have more unemployment than before the government started running trillion dollar deficits, and a far larger federal debt to boot. The U.S. government seems to be repeating some of the mistakes that prolonged and deepened America's Great Depression of the 1930s[2] and the 20-year-long economic downturn that Japan has suffered since 1990.

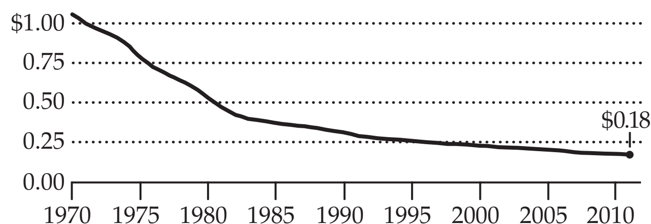
Adjustments necessary for economic recovery are in process, but the process is painful, as evidenced by the following headlines from just one week's recent issues of *The Los Angeles Times*: "Debt Fears Sink Stocks;" "B of A plans to cut at least 40,000 jobs;" "Spending on gasoline heads toward record;" "Jobless rate hits 12.1% in California;" "UC tuition may rise up to 16% a year;" "Housing defaults up in August;" and "State's Ills May Weaken Health Reform."

The way back to prosperity is through individuals, families, businesses, and government at all levels putting their finances in order. That is what ended the sharp depression of 1920-1921 and it is what averted a resumption of the Great Depression of the 1930s after the end of World War II.[3]

America still possesses the characteristics that made it great, and that provide the potential for

Not as Good as Gold

The decline in the purchasing power of a dollar



Note: Dollar deflated by CPI. 1971 = $1.00
Source: U.S. Bureau of Labor Statistics

renewed prosperity. We are a world country, inhabited by people from virtually every other country who were and still are attracted here by America's unparalleled freedom and equality of opportunity, tolerant acceptance of newcomers, and whole-hearted embrace of advances in science and technology.

Given the current economic difficulties, individuals seeking to preserve or attain financial security ought to shun speculation and follow the tried and true path of increasing their savings while adhering to a safety-first policy in their investing.

CURRENT OUTLOOK

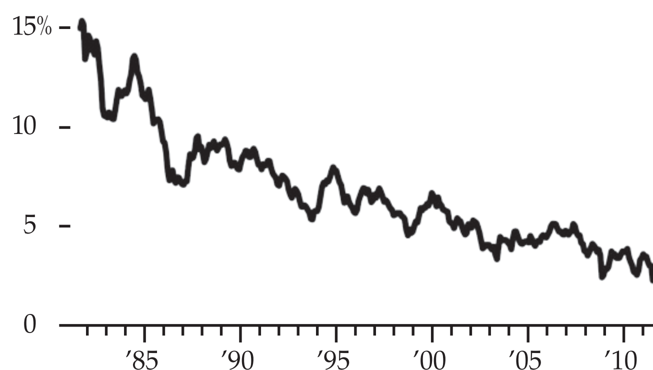
Good news about U.S. manufacturing

There are still 12 million manufacturing jobs in the U.S. (about one in 12 jobs) and the U.S. is still the world's largest manufacturing country in terms of dollar value of manufactured goods.

Within the next five years, the United States is expected to experience a manufacturing renaissance as Chinese wages are rising and the gap between U.S. and Chinese labor costs is narrowing rapidly.

Taking into account greater productivity of American workers plus inventory and shipping costs from Asia, the total cost advantage of manufacturing in China compared to low-cost states within the U.S. could become negligible or even zero over the next few years.[4] While Asia is likely to maintain its dominance in production of textiles, apparel, etc., the U.S. is likely to gain ground in production of products that are less labor intensive and are produced in smaller quantities, such as household appliances and construction equipment.

U.S. Treasury Debt:
Interest Rate at Constant 10-Year Maturity



Source: Federal Reserve Bank of St. Louis

The stock market

In the quarter ended June 30, out of concern that the stock market advance was over-extended, we increased our defensiveness by reducing our holdings of shares. Over the summer, fears of a reprise of the 2008-2009 stock market crash were engendered by the sovereign debt crisis engulfing Europe and its banking system and continued weakness in the U.S. economy. During the quarter ended September 30, the stock market, as represented by the S&P 500 fell 13.84%. In comparison our CVM Composite was down just 1.44%. The downside volatility of the 3rd quarter allowed us to make purchases of shares at prices that we believe represent bargain valuations. [See Composite Portfolio on page 7 and information about Composite Performance (and the S&P 500) on page 8.]

As value-oriented investors we must take into account the overall economic outlook because successful investing in company shares depends on reasonable future expectations. For example, a company's share price may appear low in comparison to its past earnings record. However, if those past earnings were achieved under unusually favorable conditions which are unlikely to recur for some time, then today's apparently low share price may be high in comparison to future prospects.

Large, well-entrenched multinational companies seem to us to present good value in a stock market that remains generally fully priced. The nine large, dividend-paying multinational companies in our Balanced Portfolio Composite (see page 7) have an average dividend yield of 3.6%, far better than the paltry annual interest ranging from near zero to around 1% on cash equivalents and safe, shorter-maturity bonds.

In terms of the prospects for protection of the real value of capital over time, we view shares of such companies as preferable to bonds and cash equivalents. Despite continual searching in the market, currently we do not find many such companies at bargain prices. Therefore, we have a sizable cash position. Rather than buying stocks and bonds just to be out of low-yielding cash, we watch patiently for more bargains in an overall market where we consider the risk/reward ratio in both stocks and bonds to be generally adverse.

A lower level of the overall stock market could well produce more attractive investment opportunities.

AVOIDING COSTLY MISTAKES

In our view most of the financial woes of the past dozen years have been due to misguided speculation in which people either engaged knowingly and eagerly in speculation or deluded themselves into thinking they were investing when actually they were speculating.

Victims of the multi-billion dollar Madoff Ponzi swindle have been described as investors. They were not; rather they were unwitting speculators who thought they were investing.[5] Madoff's victims included approximately 14,000 individuals, charitable and educational endowments and foundations, and pension trusts.

In 1962 then 24-year-old Bernard L. Madoff ("Madoff") established a broker-dealer business, seeking customers for stock and bond brokerage services. Over the ensuing decades Madoff built a successful Wall Street broker-dealer firm that handled 10% of the trading volume in New York Stock Exchange listed companies, in addition to sizable trading volume in companies not listed on the New York Stock Exchange.

In the 1970s Madoff earned a favorable reputation as a pioneer in electronic, computerized, low

cost trading of marketable securities. In 1990 Madoff was chairman of the NASDAQ stock market. He was respected by the U.S. Securities and Exchange Commission (SEC), the federal agency charged with regulating the securities markets.

Until late in 2008 Madoff was a wealthy, influential and respected man. Six months later, on June 29, 2009 Madoff was sentenced to a term of 150 years in federal prison, after having pled guilty to swindling thousands of people out of billions of dollars.

Starting perhaps as early as the 1960s, and certainly by the 1980s, and lasting until 2008, Madoff ran a Ponzi scheme that operated by recycling customers' money. Ponzi schemes are not uncommon.[6] All fail eventually when demands for payment by existing customers exceed receipts from newly recruited customers.

Madoff's swindle lasted much longer and bilked customers out of far more money than any prior Ponzi scheme because Madoff was able continually to increase the number and wealth of new people eager to benefit from his apparent success as a money manager. His early customers were individuals of moderate means, followed by wealthy people who entrusted Madoff with hundreds of millions of dollars, and culminating in hedge funds who brought Madoff tens of billions of dollars.

Madoff gained trust and renown among his circle of customers by supplying monthly statements showing a high and steady rise in customers' account values, with scarcely a down month, all the while reliably paying out cash promptly as requested.

Almost from the beginning Madoff paid large amounts, directly or indirectly, for other people, called "feeders," to recruit new customers for his supposed money management operation.

It was not until the financial crisis of 2008 that demands for cash back and a dearth of new customers ended the swindle.

Madoff's last statements of account showed $65 billion of customer assets. However, at the end Madoff had on hand only about three dollars for every $1,000 of stated account value.

A bankruptcy trustee determined that over the many years of fraud Madoff had taken in about $20 billion more in cash than he had paid out. The $20 billion was spent, in probable order of magnitude, first in payouts to earlier and favored customers, second as fees paid to or charged by a multitude of individuals and so-called feeder funds who steered customers to Madoff, and last by monies Madoff spent on himself, his business and his family.

There were never any money management profits because there was no profit-seeking money management activity. Madoff used a bank account to deposit receipts and pay out cash requests. He created phony monthly statements showing trading in the stock market and in stock options.

"Investors" is the term used universally to describe Madoff's victims, but were they investing? We know of no better definition of the critical distinction between investing and speculating than that of Benjamin Graham, who said: *"An investment operation is one which,* ***upon thorough analysis*** *promises safety of principal and an adequate return. Operations not meeting these requirements are speculative."*[7] [Emphasis added]

Most of Madoff's victims could not make a thorough analysis of Madoff's operation because they did not understand what Madoff claimed he was doing with money entrusted to him. When pressed for details Madoff described his activity as a *"split/strike conversion strategy that consisted of buying a basket of stocks closely correlated to an index, while concurrently selling out-of-the-money call options on the index and buying out-of-the-money put options on the index."*

It is doubtful that Madoff's individual customers understood what this meant. If one could not understand what this meant how could one do a thorough analysis to determine if the strategy is safe?

Madoff's customers included as many as 1,000 hedge funds that have been called "feeder funds" because they sent money to Madoff. The feeder funds usually employed supposedly sophisticated people who may have understood Madoff's claimed strategy but seem to have blinded

themselves to a number of red flags that indicated he was, in fact, a fraud.

Hedge funds generally are private investment companies in which wealthy individuals and institutions entrust money to a fund manager. Funds of funds are a category of hedge fund that rather than managing customers' money, turn it over to other hedge funds to manage. The supposed advantage of a fund of hedge funds is that its managers, by virtue of their expertise, will diversify its customers' money among some of the best and safest of the regular hedge funds.

Such funds of funds in aggregate sent tens of billions of dollars to Madoff – and garnered enormous payments for doing so. By 2008 11% of U.S. hedge funds had placed money with Madoff.[8] Perhaps the failure of such feeder funds to understand that Madoff was a fraud is explained by the following comment of famed American writer Upton Sinclair: *"It is difficult to get a man to understand something when his salary depends on not understanding it."*

In 1999 Harry Markopolos, a Chartered Financial Analyst at an investment management firm in Boston was asked by his employer to figure out how Madoff was doing so well in order to copy the strategy and replicate Madoff's results. Markopolos decided after only five minutes of examination that Madoff's reported performance was too good to be true, was bogus and possibly evidence of a Ponzi scheme.

After painstaking analysis, between 2000 and 2005 Markopolos met with staff of the SEC or communicated to them in writing on five occasions, to notify them that Madoff was a fraud, that the fraud involved billions of dollars and to provide a detailed explanation of many red flags which gave Madoff away.

While Markopolos convinced an investigator at the Boston office of the SEC, agency protocol required the Boston SEC office to refer Markopolos' communications to the New York office, where they were disregarded despite repeated requests of Markopolos to pay attention to what he was disclosing.

As early as 1991 several other financial experts had come to conclusions similar to those of Markopolos. In 2001, two news articles in prominent journals reported suspicions of financial industry experts that Madoff was a phony.[9]

Over the years the SEC investigated Madoff a dozen or so times, but failed to see that he was operating a Ponzi scheme. In 1992 the SEC stumbled onto information that Madoff was managing a pooled fund of $400 million that had been placed with him in violation of federal law, yet the SEC ordered only that the $400 million be returned to customers, most of whom sent the money right back to Madoff.

When Madoff had to explain away suspicions voiced in the financial industry about his operation, he pointed out that the SEC repeatedly had given him a clean bill of health.

Madoff's victims lacked the ability or willingness to make a thorough analysis of Madoff's claims. Therefore, they were speculating. There is intelligent speculation just as there is intelligent investing but people who placed money with Madoff did neither.

The dangers of speculation to society go far, far beyond even so massive a Ponzi scheme as that of Bernard Madoff. For example, in the late 1920s, speculation in real estate and the stock market destabilized America and led to the stock market crash of 1929 and the ensuing economic depression.[10]

Speculative losses from Bernard Madoff's fraud pale into insignificance compared to the losses from speculation incurred by Americans in the recent housing bubble, financial crisis, and economic recession. In the year 2008, total U.S. household net worth declined by $11 trillion, over 500x as much as the $20 billion net loss from Madoff's fraud. Some of that $11 trillion has been recouped with the partial recovery of the stock market, but much is gone forever.

There can be speculative lending. Every real estate mortgage secures a loan, and such a loan is a speculation rather than an investment if the lender does not do thorough analysis to determine the prospect of payment in full due both to the ability of the borrower to service the loan and the likely market value of the mortgaged property in event of the need to foreclose under adverse economic conditions.

Since 2007, losses on speculative real estate mortgages are in the hundreds of billions and perhaps as much as $1 trillion in aggregate at America's banks and at Fannie Mae and Freddie Mac, the two large government-sponsored mortgage agencies. Due to the extensive federal government involvement in promoting and guaranteeing residential real estate mortgage and bank deposits, America's taxpayers are stuck with the bill for these losses via federal government bailouts of banks and mortgage agencies.

In the stock market technology company bubble of the late 1990s through 2000, shares of a large number of companies were bid up to prices that could not be justified by established earning power (often there was none) or by future prospects (which often were dubious at best).

People fall prey to Ponzi schemes due to naïve acquisitiveness that induces them to disregard some defensive investment principles that are common sense, including the following.

Don't try for unusually high profits: Ponzi promoters typically promise profits that are too good or too easy to be true. That should be a reliable warning that what is being promised may be unrealistic or even fraudulent.

Know what you are doing: For investors this means don't put money into any sort of profit-seeking venture that you don't understand. For example, when customers asked Madoff to explain what he did, they received either (1) an incomprehensible answer or (2) a statement that Madoff's results were due to his ability to get out of the stock market just before it was about to go down and to get back in just before it was about to go up. In that regard famed financier Bernard Baruch said: "Don't try to buy at the bottom and sell at the top. It can't be done except by liars."

Yogi Berra, New York Yankee baseball hall of fame catcher, and master of malapropism, might put it this way: **"If you don't know what you're doing, don't do it."**

Don't give up custody of your money: In every Ponzi scheme the victims hand over their money to the promoter or an agent of the promoter. One should never give up custody of investment capital unless there are unusually good reasons to trust the integrity and the ability of the person who takes custody of one's money.

Note: Cheviot Value Management, like most investment counsel firms, puts clients' funds only into marketable securities and never takes custody of client funds. Each client's funds are always on deposit in the client's own name at a brokerage firm independent of Cheviot. Clients can check the contents and current market value of their brokerage accounts under our management 24 hours a day, seven days a week and can withdraw their funds at any time.

Speculative manias as naturally occurring Ponzi processes

Robert J. Shiller, in his important book, *Irrational Exuberance,*[11] observes that a naturally occurring Ponzi process arises in every speculative mania without the contrivance of a fraudulent manager. Eventually the supply of new buyers runs out and the last round of buyers suffers enormous losses.

Such episodes originate and develop in the activity of large numbers of people seeking quick riches; during an extended period of rising asset

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 9/30/11.

	1-year	3-year	5-year	10-year
CVM Balanced Portfolio Composite	2.20%	5.32%	4.63%	4.61%
S&P 500 Index	1.00%	1.18%	-1.22%	2.79%

prices people commit more and more money to over-priced assets (*e.g.*, shares or homes) under the mass delusion that prices will continue rising indefinitely. In the real estate and credit bubble that ended in 2007-2008, real estate lenders operated under the delusion that home prices would continue rising, justifying a myriad of improvident loans.

Benjamin Graham said about speculative manias that *"it is characteristic . . . that speculative optimism increases with the price level and the price level with the optimism."* Despairing of rational human behavior in financial affairs, Graham observed at the end of his career that *"my books are the most widely read and disregarded in financial history."*

At Cheviot we seek always to avoid speculation, and to emphasize business judgment, safety of capital, the prospects for a satisfactory long-term return and having clients' funds immediately available for their needs.

CHEVIOT IN THE MEDIA

In August our Darren Pollock was interviewed twice on Yahoo.com. See http://cheviotvalue.com/publications/cvm-in-the-media/

In its issue dated September 19, 2011 *Barron's* published an Op-Ed article by our Frederic G. Marks entitled "When It Rains It Pours," concerning problems and solutions of health care finance.

CREDITS

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

COMPOSITE PORTFOLIO

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

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

In the three months ended September 30, 2011 we initiated a position in shares of **Merck & Co., Inc.** and a **National Semiconductor bond** due 6/15/12; we added to client holdings in **Medtronic, Inc.** and **Wal-Mart Stores, Inc.** The table below sets forth the holdings in our Composite as of September 30, 2011.

Composite Portfolio Holdings as of September 30, 2011

Security	Pct. Assets
Newmont Mining	9.5
Market Vectors Gold Miners ETF	8.4
Federated Prudent Dollar Bear Fund	6.5
Berkshire Hathaway	6.2
Federated Prudent Bear Fund	5.4
Central Fund of Canada	4.9
Pfizer	3.7
Wal-Mart Stores	3.5
Johnson & Johnson	3.3
Microsoft	3.0
Pan American Silver	2.9
Medtronic	2.7
Abbott Laboratories	2.3
RR Donnelley & Sons, 5.625% due 1/15/2012	1.4
Seagate Technology, 6.375% due 10/1/2011	1.2
Leucadia National	1.1
CVS/Caremark	1.1
ConocoPhillips	1.0
Markel	0.9
Berkshire Hathaway, 7.125% due 10/15/2023	0.9
Chevron	0.8
Merck	0.8
National Semiconductor, 6.150% due 6/15/2012	0.6
Other	2.0
Cash Equivalents	25.9
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

[1] At the time, in this newsletter we reviewed books and articles warning of the danger that lay ahead, including Smithers, Andrew and Stephen Wright, *Valuing Wall Street* (2000); Shiller, Robert J., *Irrational Exuberance* (1st ed. 2000); and "Mr. Buffett on the Stock Market," by Warren Buffett and Carol Loomis, *Fortune*, Nov. 22, 1999.

[2] See Shlaes, Amity, *The Forgotten Man: A New History of the Great Depression* (2007).

[3] See "The Forgotten Depression of 1920," by Thomas E. Woods, Jr., Ludwig von Mises Institute, Nov. 27, 2009, http://mises.org/daily/3788 and Rumelt, Richard P. "World War II Stimulus and the Postwar Boom," Op-Ed, *The Wall Street Journal*, July 30, 2011.

[4] "Made in the USA, Again: Manufacturing is Expected to Return to America," Boston Consulting Group, May 5, 2011, http://www.bcg.com/media/PressReleaseDetails.aspx?id=tcm:12-75973 and "A Manufacturing Renaissance, Contrary to Common Belief," by Jerry Jasinowski [former President and CEO of the National Association of Manufacturers], *Investor's Business Daily*, May 5, 2011.

[5] Three excellent books tell the story of the Madoff swindle: *Too Good to be True: The Rise and Fall of Bernie Madoff* (2009) by Erin Ardvedlund; *The Wizard of Lies: Bernie Madoff and the Death of Trust* (2011) by Diana B. Henriques; and *No One Would Listen: A True Financial Thriller* (2010) by Harry Markopolos.

[6] Ponzi schemes are so commonplace that the North American Securities Administration Association names them first in their list of "Top 10 Scams, Schemes & Scandals" to bilk investors. North American Securities Administrators Association, News Release Archive, Release 011404, www.nasaa.org

[7] Quoted from Graham's *The Intelligent Investor* (Jason Zweig edition 2003), p. 19.

[8] Markopolos, *No One Would Listen*, note 5 above at p. 183. In Ardvedlund, *Too Good to Be True*, note 5 above at pages 275-276 it is stated that 15% of all hedge funds went out of business in 2008.

[9] Ardvedlund, *Too Good to be True*, note 5 above at pages 261-264.

[10] Anderson, Benjamin M., *Economics and the Public Welfare* (1948), chapters 17, 19, 24-27.

[11] First published in 2000; second edition published in 2005.

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