Cheviot Value Management, LLC

Investment Values

Issue Number 114, April 2015

"When experience is not retained… infancy is perpetual. Those who cannot remember the past are condemned to repeat it."
– George Santayana

CONTENTS **Page**

Our Investment Outlook 1
Nasdaq and the Number 5,000 2
Seeking Quality at an Intelligent Price 4
Composite Portfolio Update 6
Credits 7
Cheviot Composite Disclosure 7

OUR INVESTMENT OUTLOOK

There was intense volatility in currency markets during the year's first quarter, driven in large part by the reaction to ongoing economic weakness in Europe. The European Central Bank (the "ECB" is equivalent to our country's Federal Reserve or "Fed") initiated a massive quantitative easing program to fund the purchase of European bonds. The goal of increased bond buying is to lower the yields on bonds, effectively reducing the level of interest rates in a particular region. Low interest rates are meant to encourage capital investment and stimulate the economy. Worldwide, there are now $2 trillion worth of bonds trading at negative yields and another $2 trillion offering yields of less than one-tenth of one percent.

Like many a homeowner presented with the chance to refinance at record low rates of interest, corporations are lining up to issue low-yielding bonds. These include cash-rich companies of the caliber of Apple, Berkshire Hathaway, and Microsoft. Corporations such as these, with already strong balance sheets and copious cash flows, do not need the funds now. But it is sensible to have cash in the coffers ahead of when corporations will want to use it. This parallels an investor that wisely keeps cash on hand for future purchases.

When Coca Cola recently sold €8.5 billion ($9.25 billion) of debt to take advantage of even lower interest rates in Europe, buyers were clamoring for €20 billion ($21.75 billion) of bonds. The paltry rates offered on these IOUs? 1.125% for 12 years and 1.65% for those maturing in 20 years. At least this yield was positive. Nestle bonds traded with negative yields in February. (At these rates, corporations are proving *Hamlet's* Polonius to be only half-right: Be not a lender but, by all means, borrow away!)

These are interesting times indeed when many investors are in such need of safety that they are willing to lose a small amount of money knowingly for the privilege of investing in high-grade corporate and government bonds.

All the while, the Fed struggles with its own interest rate conundrum. The U.S. central bank has held interest rates near zero for an unprecedented six years. Perhaps to give itself some maneuverability in the event of a future recession, members of the Fed would like to have interest rates above zero. But they fear the consequences of actually raising them.

This is understandable. The economy remains sluggish as estimates for GDP growth continue to be revised lower. Expectations for GDP growth are now settling in between 2.0% and 2.5% for this year, similar to the average rate of growth during

Cheviot is in its 31st year of serving investment clients throughout the U.S. We deliver personalized investment and financial management expertise to simplify our clients' complex financial lives. Our firm's investment objectives are to protect and increase our clients' wealth through safety-first investing. Included within our investment management services is the creation and ongoing oversight of personalized solutions for retirement planning, estate planning, education funding, and numerous other areas of financial importance. Cheviot is a completely independent financial advisory firm. We put our clients first in everything we do.

the entire span since the Great Recession. As of the end of March 2015, Federal Reserve estimates for first quarter growth were as low as 0.0%, down from an estimate of 2.3% a month earlier.

Consider that central banks typically prefer to raise interest rates when the economy may be poised to overheat (central banks often do not raise rates until well past that point; the Fed is not one to try to end a party early). Central banks seek to lower interest rates – or enact extraordinary stimulus measures like quantitative easing – when economic activity is lower than desired. One factor making raising interest rates so difficult now is that the U.S. economy is *far* from overheating.

The "official" unemployment rate has fallen to 5.5% and is slightly higher than the level often considered by the Fed to resemble "full employment" (the Fed believes that there will always be a certain level of unavoidable unemployment). Bond investor Jeffrey Gundlach provides an update to this rationale: "It is really a mistake to compare today's unemployment rate to what would have been an unemployment rate around 6% roughly twenty years ago. Today, there is a great shift towards part-time employment." More meaningful than the official unemployment rate is the rate of "under-employed" (those who are working part-time but would like to work more). This figure hovers at 11%. Not counted in either figure are those who have stopped looking for work altogether. Moreover, the employment-to-population ratio, which measures the number of workers against the total number of working age adults – and is considered a far better measure of labor health in the U.S. – is still several percentage points below its early 2007 peak. It is also merely one percent higher than its average during the past five years.

This is why Ray Dalio, head of institutional investor Bridgewater Associates and someone former Fed Chairman Paul Volcker once referred to as having better information than the Fed itself, recently stated, "We think it would be best for the Fed to err on the side of being late [to raise rates] and more delicate than normal… We don't know – nor does the Fed know – exactly how much tightening [raising of interest rates] will knock over the apple cart." Dalio fears a repeat of 1937-38 in which the Fed raised interest rates before the economy healed from the Great Depression. This caused the economy to suffer anew, creating a "depression within a depression" as it was later called. (Quick economic trivia: the term "recession" was coined in 1937 when President Franklin Roosevelt sought the use of a word with fewer negative implications as "depression.")

Underwhelming nature of this economic recovery notwithstanding, high stock prices cause optimism among many – especially peddlers of stocks. In March, CNBC hosted a reporter from *The Wall Street Journal* who advised viewers not to pay cash for new car purchases and to instead "take out that loan and invest in stocks." He suggested taking a 7-year loan, the longest term available. Credit is due to the anchorwoman who wondered aloud "if this is insane." Just then a professional advisor chimed in, calling this "a prudent thing to do." Might as well borrow against that new car and have the money working for you, he added. (Take *that*, Polonius!)

Speaking of automobiles, Morgan Stanley released investment research on Tesla in which it stated that the company's share price could "realistically multiply by ten" but also hedged itself by saying that "it can get cut in half." We wonder if anyone finds this type of price targeting to be helpful.

Throughout financial market cycles, there are seasons in which the search for quality investments at intelligent prices yields much fruit. At other times, the opportunities are sparse. High prices are the problem, not the lack of strong U.S. businesses. As Warren Buffett recommended to investors weeks ago, "Consistently buy American businesses. American business is going to do wonderfully." We agree. And, though patience is required, the "Oracle of Omaha" added, "The best days of American investors lie ahead."

NASDAQ AND THE NUMBER 5,000

The Nasdaq Composite (or simply "Nasdaq") is the index of all stocks traded on the Nasdaq stock exchange. It is a closely followed U.S. index and is part of a trio of widely watched U.S. indices, the others being the S&P 500 and Dow Jones Industrial Average.

In March, the Nasdaq closed above 5,000 for the first time since March 2000. And this generated much fanfare. Yet is there any significant difference between 4,997 and 5,002? Other than one-tenth of one percent, the only difference is psychological. But the psychological ramifications of round numbers can have an immense impact on investors' behavior.

Round numbers often cause many individuals to project forward to the next round number. When the Nasdaq first reached 5,000 in March 2000 – spending parts of five trading days above the 5,000 mark – market participants were giddy with their predictions of when it would pass 6,000 (and even 10,000). Conversely, a few years later, when it was falling and reached 2,000, many market participants stated that the next round number to be reached was 1,000.

Neither occurred.

The NASDAQ Composite Roller Coaster Ride: 1997-2015

Yet market commentators are quick to use the phrase "a psychologically important level." What this usually means is that as prices decline for a company's shares, an entire market, a commodity, etc. – penetrating through lower "psychologically important levels" – many market participants will sell. Then they will wait on the sidelines until prices rise. The eventual return of higher prices – especially when they surpass a new round number – causes more people to feel comfortable about buying. And so they do.

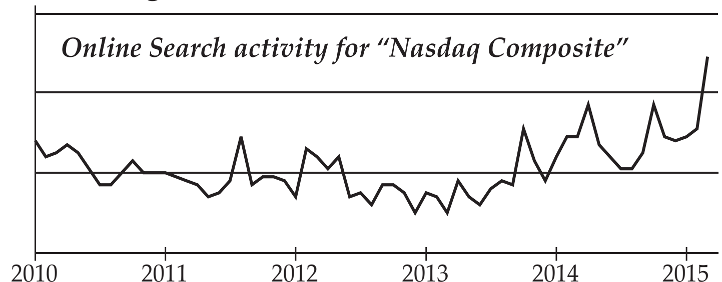
But does this make sense? Investing is unique for causing individuals *en masse* to wait for higher prices to buy and for lower prices to sell. The warmth of the crowd may provide comfort at the cost of a counterproductive investment style. For the vast majority of market participants, it is simply much easier – psychologically – to buy something that is enjoying good news, and thus offered at a high price, than something else which is under a negative perception and is available at a low price.

This is momentum investing – buying into that which is rising, selling that which is falling – and is a subset of performance chasing. It is a poor long-term method for investing. As proof, during the 15 years ended December 31, 2014, investors in Vanguard's S&P 500 Index Fund on average earned an annualized return of 1.8% at a time when the mutual fund itself earned 4.1%. This discrepancy in the fund's return and the investors' return is due to investors waiting for the fund price to rise to buy in and for selling after the fund price fell. (Incidentally, Cheviot's clients earned 4.8% annually during that time and avoided severe declines brought on by being fully invested in stocks. We do not believe that one should take more risk in the attempt to earn more return. As investor Howard Marks says, "The main thing people don't understand is that it's wrong to say, 'If you want to make more money, take on more risk.' *It can't be right*. If riskier investments could be counted on to produce higher returns, they wouldn't be riskier! It's as simple as that." But we digress.)

The nearby graph depicts the popularity of Google searches of the term "Nasdaq Composite." You can see that the trend picked up dramatically in the first quarter of 2015. Recent search activity was nearly triple that which occurred in years past when the Nasdaq was trading at lower levels.

With today's higher prices – and renewed interest in the Nasdaq – financial advisors and salespeople are coming up with new ways to justify investing (or speculating) in what is now popular again. We hear regularly that the Nasdaq is not as overpriced

The Higher the Price, the Greater the Interest



as it was in March 2000. This is true. After all, the Nasdaq bubble of 2000 was as extreme as any financial bubble ever experienced in the U.S. Valuations were stretched to unprecedented levels. Today's Nasdaq is unquestionably less expensive when measured against the most overvalued market in history. But it is still lofty. On a valuation basis, it trades higher than its average of the last several years. Furthermore, it is far higher than that which would be attractive to a true investor, i.e., one who is not willing to speculate.

Another statistic we hear often is that the Nasdaq is no longer dominated by technology companies as it was in 2000. Tech companies comprised 50% of the Nasdaq in 2000. Today, that figure is 47%. To us, this is not much of a difference.

Shares of biotech companies may currently carry the euphoric torch held previously by tech stocks. They comprise a considerable component of the Nasdaq and, as a group, trade for nearly 50 times earnings. The biotech industry is an inherently speculative one. And the last time it was this hot, tough times followed. For example, there were more biotech initial public offerings ("IPOs") in 2014 than there were at their prior peak in the early 2000s biotech bubble. (Remember, insiders like to sell when stock prices are high and carrying out an IPO is an effective way to sell huge quantities of shares to the public.) A crash followed the last biotech boom.

Many of the Nasdaq's hottest stocks require very little promotion to locate buyers. Companies like Twitter, Facebook, LinkedIn, and Yelp are considered unique businesses with terrific stories. They may in fact dominate a market niche in such a way that will create tremendous staying power (despite volumes of tech industry history to the contrary). But today's buyer of those shares gets very little in return for each invested dollar. Facebook, LinkedIn, and Yelp sport stratospheric price-to-earnings ratios ("P/E's") of 73, 89, and 358, respectively. Twitter does not yet have earnings.

Interestingly, beneath the surface of the Nasdaq is the hot market for privately held high tech companies. These companies are growing, attracting tremendous sums of capital, and many hope to eventually go public. Indeed, it is high times again for this industry, and there is much debate about whether these private market prices are approaching something of a mania. We take no side on this but Prem Watsa, the legendary value investor who heads Fairfax Financial, stated in his company's recent shareholder letter: "I am always amazed at the speculation that can take place in the stock market… and how long it can last.

"The continuing speculation reflected in the stock prices of public high tech companies has moved to private high tech companies… We're confident that most of this will end as other speculations have – very badly!"

While the Nasdaq's recent flirtation with 5,000 is not as senseless as it was in 2000, it has revealed pockets of overvaluation in the stock market. And while round numbers may make for interesting discussions, when it comes to long-term investing, what continues to make the most sense is buying, holding, and continuously monitoring companies that are sound… not round.

SEEKING QUALITY AT AN INTELLIGENT PRICE

The rational buyer of a business will strive to own a better business rather than a poor one. For example, if there are two corner stores but only one is crowded with customers and it earns far more in profits than the other store, the choice is easy. Maybe even obvious. And given the choice, the rational buyer of a share of a business will also strive to own the shares of a better business rather than a poor one.

Yet in broadly diversified mutual funds and exchange traded funds (ETFs), including index funds that may own thousands of companies, all companies of a particular size, sector, region or other widely-defined category are owned. This includes those that are profitable and those that are loss-generating; those that have shareholder-friendly management teams and those that use company coffers for their own benefit; those that have their financial house in order and those which must routinely borrow to pay off maturing debts, etc.

Warren Buffett, among others, has long championed the ownership of the best quality companies available (his secret is to buy them only when they

are available at an attractive price). In his classic 1980 book The Money Masters, author John Train says, Buffett "characterizes traditional diversification as the 'Noah's Ark approach.' You buy two of everything in sight and end up with a zoo instead of a portfolio. The essence of Warren Buffett's thinking is that the business world is divided into a tiny number of wonderful businesses – well worth investing in at the right price – and a huge number of bad or mediocre businesses that are not attractive as long-term investments."

Sorting the wonderful from the mediocre and worse requires an understanding of various facets of each business. We offer this abridged list: A company's position within its industry must be favorable, it should have products or services that are necessary, and the business should have a track record of consistent profit production. Regular and annual growth in profits is not a prerequisite – the business cycle makes that nearly impossible (absent financial embellishments perpetrated by less than honest management teams) – but it is preferred. A high quality company usually produces a clear progression of earnings growth over many years. The excellent business should also achieve high marks for its financial health (balance sheet strength), return on capital employed within the business (profitability), and the ability to produce free cash flow which it then uses in a shareholder-friendly manner (including opportunities for internal growth, complimentary or "bolt-on" acquisitions, paying down debt, increasing dividends, or buying back shares – and each of the aforementioned to be employed only when appropriate).

Buffett "characterizes traditional diversification as the 'Noah's Ark approach.' You buy two of everything in sight and end up with a zoo instead of a portfolio."

It is important that the company's top executives maintain goals that are aligned with shareholders, that they have a vested interest in the business, and are not using the company as their personal piggy bank. Furthermore, good management tends not to spend money on pursuits of empire building (growth for its own sake), instead focusing on protecting profitability for the long run. Too many companies attempt gains in the short-run, kowtowing to Wall Street's consistently myopic desire for quarterly profit growth. Said Warren Buffett in Berkshire Hathaway's 1979 letter to shareholders: "The primary test of managerial economic performance is the achievement of a high earnings rate on equity capital employed (without undue leverage, accounting gimmickry, etc.) and not the achievement of consistent gains in earnings per share. In our view, many businesses would be better understood by their shareholder owners, as well as the general public, if managements and financial analysts modified the primary emphasis they place upon earnings per share, and upon yearly changes in that figure."

Yet quality is just one factor that gets diversified away in diversified mutual funds and ETFs. The buyer of an over-diversified mutual fund or ETF is not just acquiring the shares of both high and low quality businesses, but also is paying prices both high and low for those businesses. Selectivity and the ability to pay a rational price – or better yet a bargain one – is lost.

Within each index, share prices are constantly bouncing around. In fact, the market price for a share of a business fluctuates far more than the underlying value of that share or, said another way, the actual value of the business itself.

Consider Alcoa. Founded in 1888 and earning its moniker from the phrase the "Aluminum Company of America," Alcoa is a venerable "household name" company. Annual revenues of $23 billion are essentially unchanged during the past three years, assets have fallen from $40 billion to $37 billion during that time, and net tangible equity (what the business is worth if you take its tangible balance sheet assets and subtract all liabilities) was $8 billion on 12/31/12 and is $7 billion as of 12/31/14. Importantly, profits were meager in 2012 and again in 2014. Roughly only 1% of revenues make it all the way down to the "bottom line" to be counted as profits. This is not a company that reaches our standard of a high quality business.

During the years 2012 through 2014, Alcoa's share price fluctuated more than 100%, from a low below $8 to a high above $17. Concurrently,

the market value of all Alcoa shares fluctuated between $9 billion and $21 billion. In just three years, market participants "valued" Alcoa at various points across a range of 133% its lowest valuation and by a difference of $12 billion. Recall that there were almost no fluctuations at all in the actual metrics of the business!

Why is this price range so wide? Because the company's shares are held and traded by thousands of financial institutions and millions of individuals. Each buyer and seller has his or her own reason (and sometimes not much of a reason at all) for buying and selling. Turn on CNBC on any given day and you will be bombarded with "reasons" to take action. Maybe bonds are said to be more appealing one day or emerging markets hold better promise. Furthermore, buyers are willing to pay a higher price when they are optimistic compared to when they are fearful about the future. And sellers are eager to unload their shares when they are scared about the prospects for the company, financial markets, local economy, world economy, political election, geopolitical situation… you name it.

"Help people. When people are desperately trying to sell, help them and buy. When people are enthusiastically trying to buy, help them and sell."
- Sir John Templeton

If the value of the underlying business is not wildly unstable, then we know that these wide price fluctuations are not rational. They are in large part the product of the emotions of millions of market participants, each one trying to outguess the short-term movements of the next market participant.

Sir John Templeton, legendary value investor of the 20th century, suggests a better approach. "Help people. When people are desperately trying to sell, help them and buy. When people are enthusiastically trying to buy, help them and sell."

"Helpful" advice aside, it is common that many of the reasons behind one's transactions in stocks are not influenced by a careful evaluation of what the underlying company might actually be worth.

Our quest for value, and thus future profits, in common stocks centers on our appraisal of the likely returns to us as an investor over the next several years. No one can predict the exact price of a stock ten days ahead of time, much less ten years out. However, to invest rather than speculate it is necessary to make an informed estimate of the probable range of future pricing over the long run.

It is possible to estimate a range of future market value intelligently because, to paraphrase Ben Graham, it is not necessary to know the exact amount of earnings to determine whether a company is likely to be profitable in the future. (Buffett, in a less than politically correct moment, referred to this by saying, "If somebody comes to the door, whether they weigh 300 pounds or 325 pounds, it doesn't matter: they're fat. We don't need to know more.") And it is not necessary to predict future valuations, e.g., a company's future price-to-earnings ("P/E") ratio, with exactitude to make a reasonable projection of future market valuation.

The price paid by an investor for their shares plays a large role in the return that investor can expect from their investment. This is true regardless of the company's quality, position in its industry, or "story." High quality companies can be poor investments if one pays too high a price. We need look no further than the overpriced markets of 1999-2000 and 2007 for countless examples of household-name companies that cost their investors dearly by subsequently losing tremendous sums of money.

Paying a price below that which the investor believes the company is actually worth over time provides the investor with what Ben Graham called a "margin of safety." Doing so does not guarantee success for each investment, but it increases the likelihood that a portfolio of such companies will produce satisfactory long-term results. And, importantly, with its goal of keeping the investor away from overpriced stocks, it may help to keep this individual safer than his or her peers in a significant market decline. This is an often overlooked point, especially during rising markets, and it usually concerns most investors only after it is too late.

COMPOSITE PORTFOLIO UPDATE

With half of its revenues coming from abroad,

PepsiCo's (PEP) strong international presence combined with recent strength in the U.S. dollar is causing the company's near-term earnings estimates to be revised lower. As a result, we used the opportunity of a brief decline in PEP's share price to initiate a position in the company. Over time, we expect PepsiCo and its shareholders to be rewarded for its geographically diverse sources of revenues.

In addition to its namesake brand, some of PEP's other food and beverage brands include Frito Lay and Quaker Oats products, Aquafina water, Lipton and Brisk teas, Tropicana juices, and Gatorade. The company boasts 22 different products that each generated at least $1 billion of revenues last year. PEP's strong recent operations are bolstered by new additions to its Board of Directors, most importantly in our view being the appointment of William Johnson, the former CEO of Heinz. An expected increase next quarter in PepsiCo's dividend, providing shares with a 2.8% yield at the time of our purchase, will mark the 43rd consecutive year of dividend growth at the company.

CREDITS

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

CHEVIOT COMPOSITE DISCLOSURE

Cheviot's Balanced Portfolio Composite (the "Composite") includes all fully discretionary, fee-paying accounts over $250,000 (new account minimum balance is $500,000). The Composite assets are allocated principally among the following asset classes: equities (common stocks), fixed income (bonds) and money market funds (cash).

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

Holdings are subject to change. It should not be assumed that recommendations made in the future will be profitable or will equal the performance of securities in this newsletter. The specific securities identified and described do not represent all of the securities held for advisory clients, and the reader should not assume that investments in the securities identified and discussed were or will be profitable. The information contained herein is based on internal research derived from various sources and does not purport to be statements of all material facts relating to the securities mentioned. The information contained herein, while not guaranteed as to accuracy or completeness, has been obtained from sources we believe to be reliable. Opinions expressed herein are subject to change without notice. Cheviot or one or more of its officers may have a position in the securities discussed herein and may purchase or sell such securities from time to time.

The performance results displayed herein represent the investment performance record for the Balanced Portfolio Composite, a composite of balanced accounts managed by Cheviot Value Management, LLC, a registered investment adviser under the Investment Advisers Act of 1940. The Composite returns are total, time weighted returns expressed in U.S. dollars and include the reinvestment of dividends and other earnings and the deduction of transaction charges and investment advisory fees of 1% per annum. The time period commencing July 1, 2000 is used as a standard measuring point as that is the date current investment personnel have been active in portfolio management.

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

The S&P 500 Index is a market capitalization weighted index of 500 of the largest U.S. companies. The returns for the S&P 500 Index are calculated on a total return basis with dividends reinvested. The S&P 500 Index is not available for direct investment. The Wilshire 5000 Index Fund is a fund that closely follows the performance of the Wilshire 5000 Total Market Index. Its return is calculated on a total return basis with dividends reinvested.

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

Past performance is no guarantee of future results. Any investment in marketable securities has the possibility of both gain and loss. Results will vary among client accounts. The actual return and value of an account will fluctuate and at any point in time could be worth more or less than the initial amount invested.

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

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

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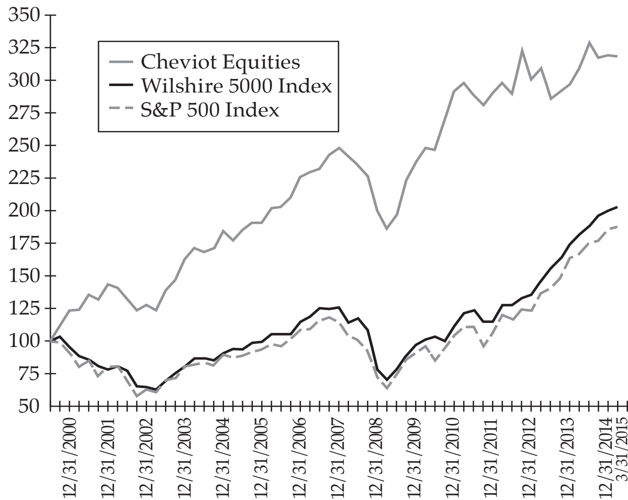
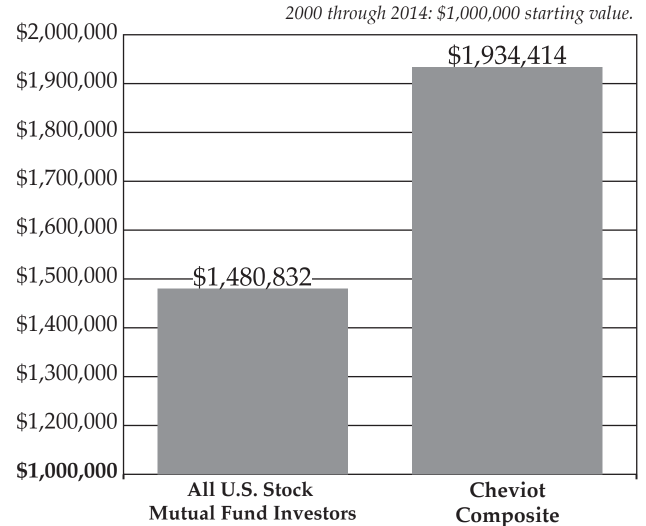
Cheviot Value Management, LLC

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

Cheviot Equities Long-Term Performance



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



Cheviot's Purpose:

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

Four principles on which Cheviot was founded:

Integrity:

Put the client first in everything we do.

Liquidity:

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

Flexibility:

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

Affordability:

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

Why Cheviot?

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

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

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

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

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

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

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