CHEVIOT VALUE MANAGEMENT, LLC

INVESTMENT VALUES

Issue Number 117, January 2016

"Be wary of the man who urges an action in which he himself incurs no risk." – Lucius Annaeus Seneca

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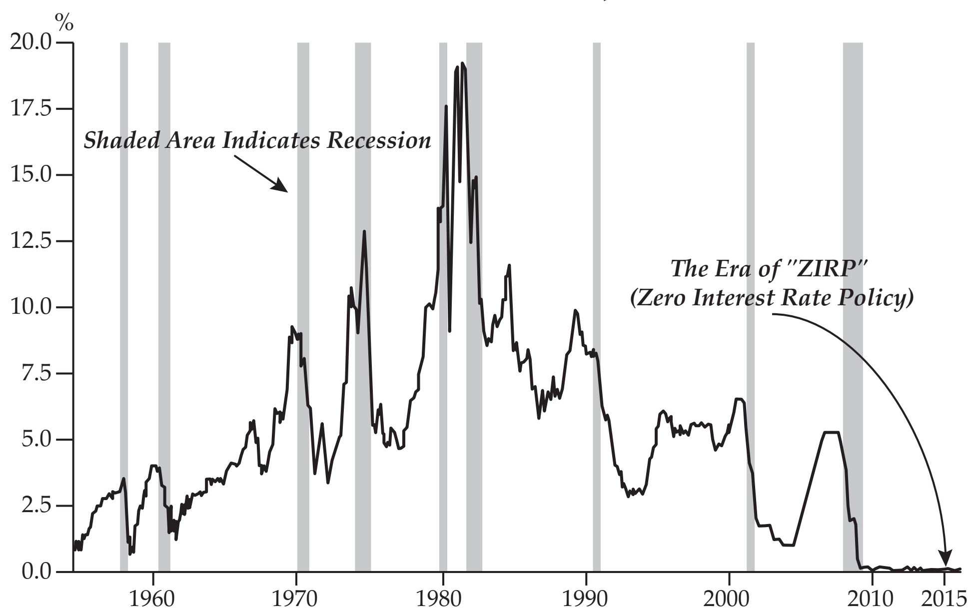
OUR INVESTMENT OUTLOOK

Within months of the U.S. Federal Reserve's attempts in 2008 to rescue domestic financial markets, the banking system, and the overall economy from the second Great Depression, it began discussing how it would soon withdraw its extraordinary stimulus and support from the U.S. economy. This so-called "exit strategy" was persistently pushed back, year after year, until the Fed attempted the first baby step toward reaching a normal level of stimulus this past December when it raised interest rates by one quarter of one percent.

More than a year ago, financial market consensus was that the Fed would begin raising interest rates early in the first half of 2015. The Fed proved reluctant to raise interest rates so soon and Fed members repeatedly stated that the Fed would raise rates before year-end. Thus, when the final Fed meeting of the year occurred in December, Fed voting members felt they had essentially no choice but to raise interest rates, otherwise send fears into the marketplace that the economy was not as strong as necessary to handle such a small and mostly symbolic interest rate hike.

Interestingly, the Fed raised interest rates in December despite disappointing economic growth and sluggish economic conditions. Financial markets of all stripes, from the bond market to all commodities, were in worse shape in mid-December than a few months earlier when the Fed was close to raising rates but did not.

Effective Federal Funds Rate; 1955 - 2015



Cheviot is in its 32nd 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.

Now we hear frequent market chatter about the trajectory of interest rates and the Fed's desire to eventually "normalize" rates, implying a level close to 4% (well above the current level of 0.25%). See the page 1 graph. Other than a brief period of time in 2006-07, interest rates have not resided at or above 4% since the robust economy of the 1990s. The path to higher interest rates will be long, slow, and quite possibly interrupted by periods when the Fed will reverse course and reduce interest rates.

This is because beneath the surface of headline low unemployment figures and relatively high stock market averages, all is not as well as one would like at this time in an economic recovery. Says investor and real estate mogul Sam Zell, "I think there's a high probability that we're looking at a recession in the next twelve months."

Stock and bond prices may already be starting to price in a tougher economic environment. Unless one gambled last year by holding in their portfolio an outsized helping of relatively overpriced shares, including Facebook, Amazon, Netflix, and a very small number of other companies, 2015 was a tough year for investors here and abroad. The NYSE Composite (all stocks listed on the New York Stock Exchange) fell in price by 6.4% in 2015. The average global stock market fell by more than 10% last year. Per Morningstar, the average of all emerging markets mutual funds submerged in 2015 by nearly 14%.

For statistical purposes, Morningstar maintains a "Wide Moat Focus Portfolio" which is comprised of very high quality companies possessing durable competitive advantages or, in Warren Buffett's vernacular, "a wide moat protecting their businesses from the competition." This portfolio of companies was lower by more than 4% in 2015. The share prices for half of the companies in this Morningstar portfolio declined by a minimum of 20%.

High quality, "wide moat" companies are exactly the type of companies that we want to own for the long run. If the market prices them attractively (*i.e.*, lower) in the coming year, we will seek to add those companies to the stable of businesses we already hold in our portfolios. Says Buffett, "Whether we're talking about socks or stocks, I like buying quality merchandise when it is marked down."

"MAYBE ZELL WILL RING THE BELL"

This is not an ode to Dr. Seuss but a consideration that, after their rebound since the great financial crisis, real estate prices are now priced better for sellers. Zell is Sam Zell, the legendary real estate investor who built not one but two giant real estate companies so far in his career. His background and current perspective follows.

The parents of Sam Zell fled Poland in 1939 shortly before the Nazi invasion. Migrating across Russia to Japan, the then-named Zielonkas eventually made their way to the United States. "My parents came to the U.S. in May of 1941. They left Poland on August 31st, 1939. My mother and father each had six siblings. Before they left, they pleaded with all of them to come with them. Not a single one went. All but two died in the Holocaust."

Through it all, Sam's father managed to keep his sense of humor. Having fun with his newly chosen name in America, the elder Zielonka liked to joke, "Maybe Zell will ring the bell."

Zell's father was entrepreneurial, the owner of a successful grain business in Poland and then a jewelry business in Illinois, all the while investing his savings conservatively. Zell paid attention to his dad's safety-first investment style. Moreover, the young Sam was already cultivating a keen eye for opportunity.

When he was 12, his family moved to a suburb north of Chicago. From there, Sam took the train south every morning to attend school in the city. One day, he spent a few minutes at the train station newsstand and noticed on its racks a new type of magazine that caught the eye of the 12 year-old boy. The magazine was the first publication by a Chicagoan named Hugh Hefner. Zell found it, well, appealing… and in more ways than one. He bought numerous copies of Playboy for its 50-cent cover price, brought them back north after school, and sold them to his buddies for $3 apiece. Zell repeated this with each new issue of the magazine. The 12 year-old boy had become a businessman.

Later, Zell attended undergraduate and law school at the University of Michigan. Says Zell: "I was a junior at the University of Michigan and a

friend of mine lived in a small town house. The guy who owned the house came to my friend one day and said, 'I bought the house next door. I'm going to rip the house down and build a fifteen unit apartment building.' I said to my friend, 'Why don't we convince him to let us rent [out] the apartments. We're students – we know what they want.' We put together a little brochure and presented it to him. He bought it. That was my first exposure to the real estate business. It turned out we were really good. The result was that other owners came to us and gave us more buildings. Then I started buying buildings. By the time I graduated law school we managed about 4000 apartments and owned about 100-200 apartments."

Sam Zell's investing motto:
"When everyone is going left, look right."

After law school, Zell sold his apartment management business to his partner, moved to Chicago, and struggled to find a job in the legal profession. Firms were not eager to take a chance on the independently-minded deal-maker. Upon finally landing a job, Zell quickly left the firm. Despite his abrupt departure, the legal partner for whom he worked was so impressed with Zell that he agreed to invest alongside him in future endeavors.

Zell discovered that, in real estate, location was indeed everything – just not in the ways that many believed. Instead of purchasing expensive properties in the best locations of the most popular cities, Zell was able to find values in mid-sized cities where major investors were not investing large sums of money and driving up prices. His first purchase was in Toledo, OH, followed by the acquisition of hundreds more units in Madison, WI, Lexington, KY, Tampa and Orlando, FL. Zell's business was growing so quickly that he contacted his business partner from his college days and requested that they again join forces in this larger enterprise. From here, Zell and Robert Lurie repeatedly acquired struggling apartment properties, refurbished them, and eventually sold them at a premium. Equity Residential Properties was born.

"In the early 1970s, we were buying apartment units at $10,000 and they cost $20,000 to build. My thesis was that if it was a good location and reasonably built, then I was competing in the market at $10,000 and new people would have to compete at $20,000 or $25,000."

Good luck finding opportunities like those today.

Zell made a flurry of acquisitions when the real estate market collapsed in 1974. Low prices were not contained to the apartment industry. Zell capitalized on the real estate bear market and began acquiring large office buildings. This was the formation of Equity Office Properties, what later became the largest owner of office space in the United States. "In the mid-1970s, I did $3 billion worth of distressed acquisitions and was able to do them with very little cash," Zell later reflected. For his ability to capitalize when others struggled, he gave himself the moniker "the Gravedancer."

The highs and lows of the economic cycle followed. Real estate prices rose and fell along with economic growth and setbacks. Much like nearly all of the players in the property market in the late 1980s and early 1990s, Zell's investments were not immune to the struggling real estate market. But,

Zell Rang the Bell

U.S. Real Estate Prices as Measured by the iShares U.S. Real Estate ETF; 2000 - 2015

over time, Equity Office and Equity Residential continued to grow and, in going public, became the kingpins of the Real Estate Investment Trust ("REIT") industry.

Zell's companies were beneficiaries of the great real estate bull market of the 2000s. The values of his companies mushroomed as investors bid higher the prices of all types of real estate. "When everyone

is going left, look right," is one of Zell's investing mottos. And when everyone had poured so much money into real estate that prices were suddenly too high to ignore, Zell came to a bold realization: it was time to sell one of his babies.

In the heady real estate market of late 2006, Zell easily found a buyer for Equity Office Properties. The Blackstone Group paid $39 billion to Zell and his shareholders, establishing a new high watermark for the largest-ever real estate transaction. In what turned out to be a high-stakes game of hot potato, Blackstone sold $30 billion worth of properties within the first several months of taking ownership. In the past year, it has unwound the majority of its remaining holdings. Office properties in West Los Angeles and Boston, still emblazoned with the Equity Office Management banner, are the final batch of buildings held by Blackstone. They are slated for sale soon, too.

The real estate market topped out within months of Zell's sale of Equity Office. When the bubble burst, prices were in freefall and his shareholders, for whom he cashed out, were protected. Equity Residential, still a public REIT, saw its price decline dramatically but the company would survive the downturn. Expectedly, Zell added properties during the decline and his largest acquisition came at the expense of Lehman Brothers.

Longer-term Cheviot clients will remember our investments in REITs in the 1990s until the time when they became overpriced in the mid-2000s. In October of 2006, we sold our position in ArchStone Smith Residential Properties, an owner of top tier apartment complexes, when its share price far outstripped our calculation of the company's underlying value. Within months, Lehman Brothers, the investment banking and management firm, acquired the entire company at an all-time high valuation. The large amount of debt that Lehman took on to acquire ArchStone contributed to Lehman's demise one year later.

In 2012, Lehman's bankruptcy estate sold ArchStone to a joint venture consisting of Zell's Equity Residential and another REIT. The $16 billion purchase price was $6 billion less than what Lehman paid in 2007.

Applying that lesson of conservative investing from his father so long ago, Zell is happy to hold cash and wait for better opportunities, even when interest rates are low.

Since Zell's 2012 purchase, property prices are on another upward trajectory. In 2015, Zell decided it best to sell a large stake of his Equity Residential's apartment complexes. He chose to sell approximately 25% of the company, more than 23,000 apartment units, and found a buyer in real estate investor Barry Sternlicht's Starwood Capital. The sale will net $5.4 billion for Equity Residential – all of which will be used to pay down debt or return as cash to shareholders. Until recently, Zell's company was gradually selling its suburban properties while simultaneously increasing its presence in the largest U.S. cities. No more. Significantly, not a single dollar from this sale will go toward buying real estate.

After the deal was announced, Zell said that his company has become "less aggressive as buyers of assets." The savvy deal-maker would never say that he's become quite aggressive as sellers. Said Equity Residential's CEO, David Neithercut, "This is an extremely opportune time for Equity Residential to monetize our investments in this portfolio of assets." The company will now focus exclusively on large urban markets as it expects that prices in second tier cities are more at risk of decline due to increased housing supply and possible interest rate increases. While Zell and Neithercut are continuing to hold their highest-quality apartments in the most population-dense U.S. cities, they have improved Equity Residential's balance sheet and are better prepared for whatever may come.

Regarding the commercial real estate market, Zell commented in late 2015, "Prices are pretty high. Yields are very low. And as an investor, unless there's a particularly unique situation, I'm a seller rather than a buyer." Making the analogy to a baseball game, he believes the property market's upswing is in the 8th inning. Applying that lesson of conservative investing from his father so long ago, Zell is happy to hold cash and wait for better opportunities, even when interest rates are low.

Days before Zell's sale, the Blackstone Group paid $5.3 billion to acquire the Stuyvesant Town housing complex in Manhattan. Whether history is rhyming, repeating, or not will be determined over time. But a whiff of 2006-2007 is certainly in the air.

Zell has proven to have an uncanny ability to be a real estate buyer during times of economic distress and a seller when ebullience pushes prices to new heights. As it relates to peak prices, there is an expression about financial markets which states: "they don't ring a bell at the top." In this case, we wonder if Zell, once again, rang the bell.

FROM ARUBA… WITH YOUR MONEY

"I think I've been in the top 5% of my age cohort all my life in understanding the power of incentives, and all my life I've underestimated it. Never a year passes that I don't get some surprise that pushes a little farther my appreciation of incentive superpower." – Charles Munger

Investopedia.com defines an annuity as follows: "a contractual financial product sold by financial institutions that is designed to accept and grow funds from an individual and then, upon annuitization, pay out a stream of payments to the individual at a later point in time." And while that definition is straightforward, it is also where the simplicity ends. In a column we wrote for *Barron's* in 2009 titled "Designed to Deceive," we said about annuity products, "They are so complex that few individuals could, even if they tried, understand how they really work. What people can understand, however, is the sales pitch – which can be deliberately misleading."

Due to how profitable these products are for both the originating financial institution and the salesperson motivated by high commissions, sales of annuities continue to grow rapidly in the U.S. In 2014, more than $235 billion worth of annuities were sold to individuals.

We continue to witness tremendous abuse of unsuspecting buyers of annuities. These individuals are often verbally promised higher returns than are delivered. Sure, the prospectus states that the annuity will employ "monthly averaging," "participation rates," "spreads," and "caps," to bring that future investment return down below what the buyer assumes he or she will receive at the time of purchase. But the average individual has no idea of what that means. As we wrote in a March 2006 column also in *Barron's*, "Understandably, the average customer won't even try to read the annuity prospectus' 100 or more pages of complex and impenetrable terminology."

We hear regularly from people who believe that annuities are a "can't lose" proposition. Future income is supposedly guaranteed, downside protection is in place, some growth is possible, and, well, it just seems too good to be true. Many consumer advocates, on the other hand, recommend individuals to think of these as if they are being offered inside of a casino where you *know* the house has the advantage. Yet in the case of annuities, you are told that you do.

Having helped establish the U.S. Consumer Financial Protection Bureau, Massachusetts Senator Elizabeth Warren receives no affection from major banks and financial institutions. Last year, the aggressive peddling of annuities drew Warren's attention. "I got interested in what kinds of kickbacks some of these insurance salesmen were getting when they pushed people to buy annuities. And what I found is pretty amazing. I found free cruises, luxury vacations at five-star resorts, an African Safari, private yacht tours of the Mediterranean, iPads, Mercedes-Benz leases, and – get this one – a diamond encrusted, NFL Super Bowl-style ring with a large ruby in the middle."

Incentives include vacations to Aruba and Hawaii, lodging at Ritz-Carltons, and tours of the Mediterranean on a private yacht. One such perk is a 30-day around the world trip with time spent in Bora Bora, Monte Carlo, and Rome. Says Warren, "These trips are so frequently used as incentives for agents to sell annuities that [the insurance industry's] field marketing organizations have turned into glorified travel agencies."

In the spring of 2015, Warren sent letters to the 15 largest financial institutions that sell annuities, requesting information on how these products are sold. Two firms disregarded her request complete-

ly; the other 13 provided incomplete responses. In her letters to Ameriprise, AXA, Lincoln Financial, MetLife, and TIAA-CREF, among others, she described annuity salespeople as "more interested in earning perks than in acting in their clients' best interests." Warren quotes a financial analyst, Frank Armstrong:

"Because the business is highly profitable [to the insurance company], and the product difficult to sell, insurance companies pay obscenely high commissions. These commissions are just the right incentive for highly motivated product salesmen, but may not lead to appropriate recommendations for consumers. It's not an accident that objective, fee-only advisors hardly ever recommend annuities, while commissioned people seem to love them."

Commissions are usually in the range of 4% to 6% of the annuity contract. The buyer of a $750,000 annuity, for example, will often pay at least $30,000 to the sales agent. Add to that ongoing annual fees that can average 3%. Finally, if the annuity-holder wishes to cash out of their annuity, the seller will be levied a "surrender charge" that declines the longer one holds the annuity (all the while paying that high annual fee). We have seen surrender charges higher than *10%*.

Stan Haithcock is a consumer advocate with respect to annuities. He states, "We are all familiar with Senator Warren's tenacity for consumer protection… and her recent focus on agent sales incentives in the wild west of annuities is a welcomed spotlight for hopeful change."

Warren believes changes are required and that compensation to sales agents is made more clear and regulated. Haithcock concurs, "Agent recommendations are too often motivated by the trip they will go on or the gift they will earn if they sell enough of a particular annuity. This lack of industry regulation obviously fosters inappropriate sales practices."

In October of last year, Warren provided the findings of her information request in a report titled, "Villas, Castles, and Vacations: How Perks and Giveaways Create Conflicts of Interest in the Annuity Industry." A strong insurance lobby supports currently weak regulation that makes it "perfectly legal for some advisers to steer customers into complex financial products that will earn the highest rewards, perks, and prizes for the advisers – even if they are bad options for their customers."

"No company clearly described the nature and type of rewards, or the locations of annual trips provided to agents, in its annuity prospectuses. None of the disclosures clearly reveal that these perks may create incentives for the agent to put his or her own interests ahead of those of the consumer."

One firm did mention, however, that its customers should ask how the agent will be compensated. This was mentioned on page 135 of the prospectus. Another firm states on page 55 of its prospectus that it has provided kickbacks to agents worth up to $9,070,316.

"I'm sure that lawyers would have a field day in any annuity complaint proceeding if they find out that their client bought an annuity that just so happened to help qualify the agent for five days and four nights at some swanky resort," says Haithcock.

Warren's report also describes "seniors being sold high-cost annuities, losing tens of thousands of dollars of their nest eggs on management costs, commissions, and other fees. Other stories have emerged about inappropriate products, such as the sale of long-term annuities to wholly inappropriate individuals, such as people who have already surpassed their life expectancies or to individuals with terminal illnesses."

Warren supports a Department of Labor proposal that "would close the loopholes in existing law by requiring that all advisers who give retirement advice specifically directed to an individual investor must act in the best interest of their clients. This means that a retirement investment adviser cannot steer a customer to an inferior product simply because it boosts the adviser's own income or comes with an enticing giveaway. It would also require that advisers clearly and prominently disclose any conflicts of interest, such as luxury vacations or NFL Super Bowl-style rings instead of burying these disclosures in the fine print."

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 $1,000,000). 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, in March, 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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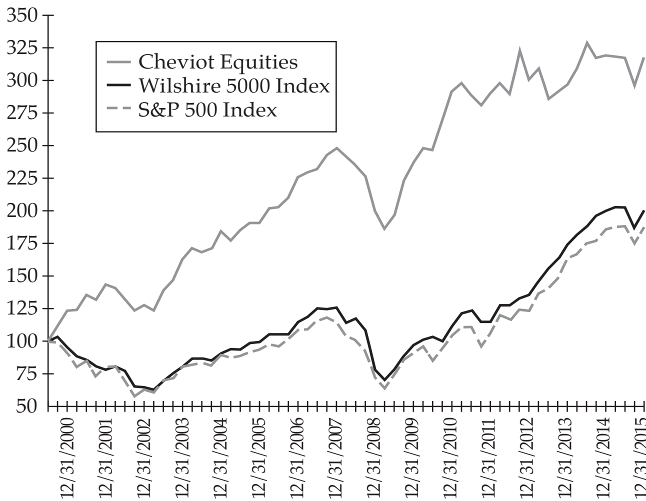
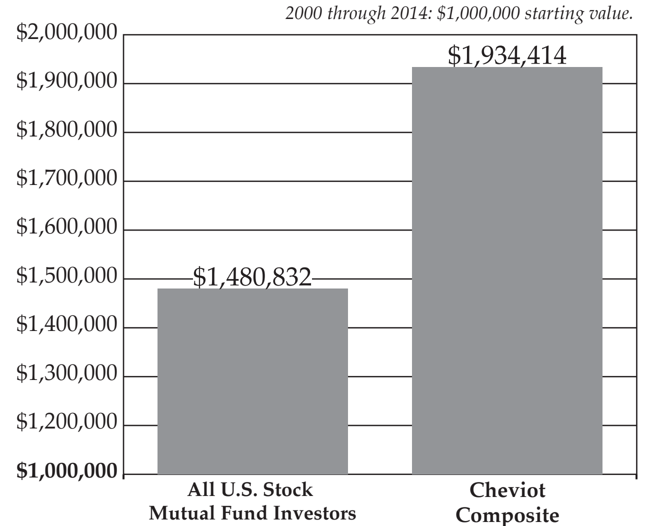
Cheviot Value Management, LLC

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





Cheviot'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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