Cheviot Value Management, LLC

Investment Values

Issue Number 115, July 2015

"Our goal has always been to seek reasonable returns over a very long period of time. I don't know why anyone would look at a short time horizon. In my life, I invested over decades. Looking for short-term gains doesn't aid this process."
– Irving Kahn, professional investor with *88 years* of experience

CONTENTS **Page**

OUR INVESTMENT OUTLOOK

Major stock market averages in the U.S. ended the second quarter almost exactly where they began the year. Yet much of the anxiety in financial markets stems from events occurring abroad.

The slow motion train wreck that is Greece's government finances picked up steam in the quarter just ended. As we went to print, the Greek government was in arrears on its payment of $1.7 billion worth of euros to the International Monetary Fund (the "IMF"). This is the largest missed payment in the 70 year history of the IMF, the first time by a developed economy, and it puts Greece in a class with Somalia, Sudan, Zimbabwe, and Afghanistan.

Though it consumes financial headlines, the size of the Greek economy should be put in perspective. With a 2014 GDP of roughly $240 billion, it comprises less than 1.3% of the aggregate economy of the 28-country European Union. If Greece were a U.S. state, it would rank between Oregon and Alabama in terms of economic size. Though there may be an indirect and transitory impact on economic activity elsewhere in the world, we see no long-lasting operational impact on the types of multinational businesses that we like to own.

There was volatility of a different kind in China as the Shanghai Composite exhibited signs of both an inflating bubble and its bursting in this year's first half. Chinese share prices rose more than 50% in the year's first five months then quickly nosedived 15% from their peak in June and fell another 13% in the first three days of July. Individuals and corporations alike were day trading frenetically with the hopes of securing profits and avoiding the fate of countless market participants who have previously tried their hands at this losing game.

Here in the U.S., the Federal Reserve (the "Fed") continues to talk about raising interest rates and ending "ZIRP," its **z**ero **i**nterest **r**ate **p**olicy. Market pundits, many of whom earlier predicted rate hikes to occur in January, then March, then April, then June, are now leaning toward a September rate hike of 0.25%. Whatever the lift-off date, we expect the pace of interest rate increases to be quite slow. Economic activity in the U.S. is fair but not robust, financial markets are increasingly reliant upon low rates, and the potential for a strong U.S. dollar to be made only stronger by rate hikes are all weighing heavily against the Fed's ability to lift borrowing costs. Its desire to effectuate higher

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.

rates remains the same: by raising rates now, they can be lowered in the future if economic or market conditions weaken. The question in the meantime is: will raising rates cause such conditions?

Low interest rates throughout much of the world are causing some unusual happenings in many markets. For example, in last quarter's letter we described how companies that were already flush with cash were borrowing even more money because interest rates were very low earlier in the year. On the other side of this transaction were countless investors lending money to these corporations at rates below 2% with maturities as far out as 20 years. Some corporate bonds and many shorter-term German bonds traded at negative yields a couple of months ago. Buyers of these were virtually certain to lose money. (Would you put money in a CD if the bank offered you a negative rate of interest?)

Unlike how an individual looks at his or her CD at a bank, as interest rates in the marketplace rise and fall, bond prices fluctuate inversely. Falling interest rates drive higher the price of existing bonds and rising rates drive prices lower. In the first quarter of 2015, Berkshire Hathaway's sale of bonds in the European market (to take advantage of rates there being even lower than in the U.S.) offered a yield of less than 1.65% and a maturity in 2035. The offering size of $3 billion was met with market demand for $7.5 billion. Within a couple of months of the deal's completion, small yet meaningful increases in European interest rates caused bond prices to decline. In what seemed like no time at all, the buyers of those Berkshire bonds had paper losses of roughly 10% of principal value.

Around the time Berkshire sold those bonds, the company's CEO Warren Buffett stated, "There is a good chance, who knows what the probability is, but that a 30-year bond, with a 2.5 percent coupon… that bond could sell at 60 very easily sometime in the not-too-distant future." By selling "at 60," Buffett is describing a *40%* loss in principal value. So much for bonds always being safe. Buying longer-term bonds, in an attempt to earn a little more interest in this income-starved environment, to us remains a risky endeavor.

AN UBER UPDATE

Uber is the extremely fast growing worldwide car service provider. The company's relatively low cost offering, convenience, and speed of service caused this 2009-founded company to disrupt the taxicab industry dramatically. One year ago we attempted to describe in these pages the domestic and international taxicab market and Uber's place in it. We subsequently received questions from numerous clients akin to, "Is this company's market value not *insane*?" We explained how relatively new companies are often valued according to their *potential* future earnings whereas more mature companies are priced against nearer-term expectations of *actual* earnings. Moreover, Uber's growth is truly tremendous. And, as we concluded in that year ago article, we maintained a positive stance on the company's future market value. This despite what many perceived at the time to be an already-outlandish valuation of $18 billion.

Fast-forwarding to this past quarter, Uber's private market valuation is on the verge of eclipsing $50 billion. For perspective, when Facebook was the same "age" as Uber – little more than five years old – its worth was pegged at $15 billion. For more perspective, all shares of FedEx, which was founded 44 years ago, are today worth $49 billion.

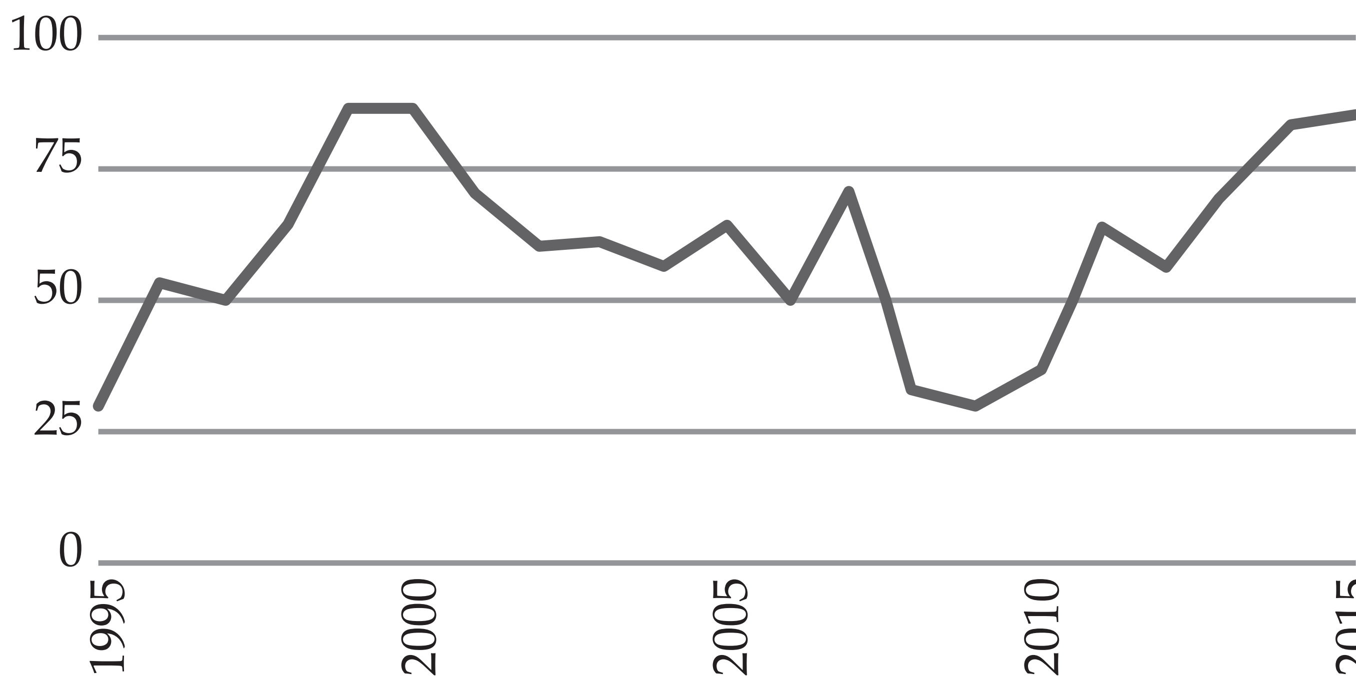
Uber possesses arguably the most robust real-time logistics network in the world's most major cities. From this foundation, the company is hoping to provide other types of delivery services. Such offerings include messenger and same day services (via "UberRush"), lunch delivery ("UberEats"), and the bundling of packages with people currently transported by Uber's traditional services. At more than 200,000 drivers, the company has nearly twice the number of worldwide drivers as UPS. Uber plans to build out its operations in China by investing more than $1 billion there this year alone. The company's stratospheric growth and potential to enter other lines of business make it no surprise that private market investors have bid up its valuation so dramatically.

Billion dollar companies inhabit the tech start-up landscape these days in a way that reminds many of the greatest of all boom periods – the late 1990s tech bubble. It is said that many of the operators of today's companies learned from the carnage of that wreck. Just one example is the successful grocery delivery service that goes by the name Instacart. Grocery delivery is not new and, in fact, was tried by a handful of companies in a previous mania, perhaps most famously by Webvan. Large capital costs to build out the infrastructure paved the way for the demise of those companies. Instacart, like Uber, neither pays for nor owns the delivery vehicles. (Refrigerated trucks were a large sunk cost in Webvan's case.) In very simple terms, Instacart, like Uber, maintains software and relationships with grocers and buyers to match customer needs with grocery stores and individual drivers able to meet them.

To us it remains unknown whether or not many of today's investors in private market tech companies have learned lessons from the bursting of previous bubbles. There are an increasing number of examples of private tech companies that are making ambitious revenue growth projections. Pinterest, for example, projects $3 *billion* of revenues in 2018 against $25 *million* in 2014. In many cases, "revenues" may be the incorrect term since it does not describe money going to a business but, instead, money generated by a particular business' service. Think of the total dollar value of goods sold via eBay versus the fees collected by eBay from the sellers of those goods; the former is not revenues, the latter is. Aggressive use of financial accounting in the tech industry was formerly this prevalent during the dot-com bubble of 1998-2000 when growth in "eyeballs" (*i.e.*, visitors to a website), regardless of its impact on revenues, drove market prices higher.

There are currently more loss-making enterprises going public via IPOs than at the peak of the 2000 tech mania. (See graph below.) In that regard, today's sellers recognize a good opportunity. Public buyers of these shares on the open market may be getting less than is hoped for. Potentially sky-high valuations for fledgling and not-yet-profitable enterprises never provided opportunities for slow-and-steady investors like Irving Kahn who said last year at age 108, "Great enthusiasm in a company or industry is usually a sign of great risk."

Percentage of Profitless Tech IPOs



THE LIFE OF KAHN: 109 YEARS OF WISDOM

"I'm at the stage in life where I get a lot of pleasure out of finding a cheap stock."

– Irving Kahn, at age 107 in 2013

Though not widely known in the general public the way Warren Buffett or George Soros have become household names, Irving Kahn is revered by a number value investing junkies. He passed away earlier this year at the age of 109.[1] [See: Notes on page 7] Kahn continued to work and give interviews until just months before his passing. We collected much of his wisdom herein during the past 20 years as Irving provided it through interviews while he was in his 90s and early 100s.

Kahn began his career in 1928 on the floor of the New York Stock Exchange. The hustle and bustle was not suited to his temperament; quiet investment research soon became his preference. In the office building where he worked, Kahn befriended a gentleman at another firm. "The head bookkeeper at the firm was a nice guy and he saw how skeptical I was about that crazy market." "That crazy market" was the market of 1928-1929, eclipsed in its ebullience only by the 1998-2000 mania. The bookkeeper showed Kahn the transactions of another investor whom he thought Irving would admire. That other investor turned out to be the person later referred to as the "father of value investing," Ben Graham.

Kahn quickly struck up a relationship with Graham and became his assistant. Says Kahn, "In the 1930s, Ben Graham and others developed security analysis and the concept of value investing, which has been the focus of my life ever since. Value investing was the blueprint for analytical investing, as opposed to speculation."

"The main lesson I learned from Ben was the distinction between investment and speculation. It's still the most important lesson an investor needs to know."

Graham taught Kahn to calculate what he thought a company was worth and then buy shares of that company only if the market offered those shares to him at a lower price. This requires considerable patience. Says Kahn about Graham: "Most of the time he passed." The price wasn't right. "There are always good companies that are overpriced. A disciplined investor avoids them. As Warren Buffett has correctly said, a good investor has the opposite temperament to that prevailing in the market."

"During the Great Depression, I could find stocks trading at tremendous discounts. I learned from Ben Graham that one could study financial statements to find stocks that were what he called a 'dollar selling for 50 cents.' He called this the 'margin of safety' and it's still the most important concept related to risk."

"You don't have to be very smart to find value" during economic depressions such as that of the 1930s. At other times, the investor needs to seek value in less popular areas of the market. "We basically look for value where others have missed it… When investors flee, we look for reasonable purchases that will be fruitful over many years. Our goal has always been to seek reasonable returns over a very long period of time. I don't know why anyone would look at a short time horizon. In my life, I invested over decades. Looking for short-term gains doesn't aid this process."

"As Warren Buffett has correctly said, a good investor has the opposite temperament to that prevailing in the market."

Kahn would buy shares with the expectation of holding them for a minimum of three years and usually more than five years. He often held his positions for 20 or more years. Once found and acquired at an intelligent price, it often makes sense to keep a company's shares for the long term. In contrast to Wall Street's myopia, Kahn had *tremendous* patience and discipline. Compared to Kahn, the average U.S. stock mutual fund is a frenetic buyer and seller of shares, trading so frequently that it turns over 85% of its portfolio each and every year.

"We approach the stock market not as traders, not like Jim Cramer, or the guys at 'Fast Money' [a CNBC program]. We approach it from an analytical point of view. We want to know about the business [that we own], and we want to own stocks that we can feel comfortable with, even if they close the stock exchange for five years."

"The thing that makes our style different from the typical firm is that we read much more broadly outside Wall Street. One reason that it's hard for many people to manage money is that they're influenced by what other people do. Buffett's not like that."

Also in opposition to Wall Street convention, Kahn viewed cash in one's portfolio as an asset to be deployed only when safe opportunities were present. He preferred holding cash, and often a great amount of it, to owning stocks if stocks were not available on his terms – *i.e.*, at bargain prices. "You don't have to be fully invested all the time. Have patience. Keep your standards."

"I would recommend that private investors tune out the prevailing views they hear on the radio, television and the internet. They are not helpful. People say 'buy low, sell high', but you cannot do this if you are following the herd."

Kahn, like his teacher Graham, was disciplined. And his penchant for bargains was equally on display in his daily life. Even in his 100s, Irving would often walk to work from his home on Madison Ave. and he eschewed taxi cabs because he thought the cost was outrageous.

Kahn's investment portfolios stood apart from the crowd, too. His results bore little correlation to the movements of the overall stock market. In rapidly rising markets, his clients' portfolios lagged the returns of the S&P 500 by a wide margin. And, despite a long track record of success, Kahn would lose clients during such periods – usually shortly before markets would regain their sanity by way of much lower prices. The siren song of the market is hard to ignore, though it continually steers individuals onto rocky shores.

Investing is a complex struggle against one's emotions, requiring an understanding that the process is a mixture of both art and science. There are no sure-fire, step-by-step procedures to success, believed Irving. He advised against putting one's faith in so-called "proprietary methods," as Wall Street would (mis)lead many to believe. "All the kids that believe in equations and rules?" Kahn scoffed. "They will learn more as they get older."

Individuals should be more skeptical of Wall Street. "We live in an era with too much confidence in advertising. Everyone tells you that you can attend a seminar for $250 and make lots of money." Kahn's recommendation was to pass on that the way he and Graham would pass on the majority of potential investments. "Value investing means being much more discriminating."

"John Maynard Keynes was one of the most famous economists in history. He was a genius, but he failed as a macro investor. It was hard to believe at the time. But when he became a bottom-up value guy, well, he became very successful… Value investing will almost always be right."

By spending one's time focused on the businesses whose shares he or she owns, the investor is better able to maintain a business-like approach to investing. "I would recommend that private investors tune out the prevailing views they hear on the radio, television and the internet. They are not helpful. People say 'buy low, sell high', but you cannot do this if you are following the herd."

"You must have the discipline and temperament to resist your impulses. Human beings have precisely the wrong instincts when it comes to the markets. If you recognize this, you can resist the urge to buy into a rally and sell into a decline. It's also helpful to remember the power of compounding. You don't need to stretch for returns to grow your capital over the course of your life."

Kahn was a buyer, not seller, of shares during large market declines. When the 2008 crash occurred, he was unemotional. "This is not so new to me. It's like the same play or plot with different characters." Lower prices are opportunities. "Investors have no reason to feel bearish. True value investors are glad when the markets are down."

Despite his successful track record and decades of experience, even Irving fielded numerous calls from clients who were not so glad during that 2008 market meltdown. Many clients wanted him to sell their stocks and raise their levels of cash (the opposite of what Irving knew was right). Asked in October 2008 what he was saying to those clients, he replied with a bit of humor: "I tell them to get a life. Stop watching TV. Drive up the Hudson. The fall colors are beautiful this time of year."

"The public is spellbound by daily price moves." Yet Irving paid almost no attention to the market's daily action. "I don't watch it, because I'm not a trader." He studies the companies he owns and those that he is considering for investment.[2]

"During the recent crash [of 2008] and in other selloffs, I looked for good companies selling at a discount, which do surface – if you're patient. If the market is overpriced, an investor *must* be willing to wait."

In August 2014, Kahn was having a tough time finding bargain securities. "I try not to pontificate about the market, but I can say that my son and I find very few instances of value when we look at the market today. That is usually a sign of widespread speculation. But no one knows when the tide will turn. Those who are leveraged, trade short-term and have bought at high prices will be exposed to permanent loss of capital. I prefer to be slow and steady."

"I've seen a lot of recoveries. I saw crashes, recoveries, World War II. A lot of economic decline and recovery. What's different about this time is the huge amount of quote-unquote information. So many people watch financial TV – at bars, in the barber shop. There is this superfluity of information, all this static in the air. There's a huge number of people trading for themselves… It's a hyperactivity that I never saw in the '40s, '50s, and '60s."

"Sticking to value investing helped me to preserve and grow my capital. Investors must remember that their first job is to preserve their capital."

The hyperactivity and static create a level of noise that runs counter to thinking rationally about investing. "Leave your feelings out of it. Buy the out-of-favor, the unpopular. Think value. Think downside risk. Think total return, with dividends tiding you over. We're in a period of extraordinarily low rates – be careful with fixed income. Stay away from options." He sums it all up: "Protect yourself."

COMPOSITE PORTFOLIO UPDATE

During the quarter, we initiated what we expect to be a long-term position in the shares of Precision Castparts (ticker: PCP). Founded in 1949 and headquartered in Portland, Oregon, Precision is the world's largest manufacturer of highly advanced castings, forgings, and fasteners to the aviation industry (from which it derives nearly 70% of its sales). The company's remaining 30% of sales come from customers in the energy, automotive and medical industries. Precision maintains loyal and longstanding customer relationships with the world's largest jet engine manufacturers (including GE, Rolls Royce, and Pratt & Whitney) and the world's foremost aircraft builders (Boeing and Airbus). There are additional significant barriers to competing with Precision in the form of it being the low-cost provider in its industry (enabling it to pass cost savings through to its customers), its technological advantages and uniqueness of product offering make it well-entrenched in airline manufacturers' supply chains causing great difficulty for its customers to switch suppliers, and the long lead times required for regulatory approval of new and highly critical airline components.

The decline in the share price during the last year from nearly $275 to below $210 at the time of our purchase was created by a combination of factors: 1. destocking of inventory at Rolls Royce temporarily reduced demand from that customer and stoked fears that Precision was losing market share to competitors; and 2. in the wake of falling oil prices, a reduction in demand from its oil customers caused the market to lower the value placed on this portion of the company's business. Earnings at Precision this year will be less than previously forecast.

We believe these setbacks will prove temporary. New aircraft production is expected to grow nicely in the years ahead and the company expects the dollar value of its components sold into new jet engines to rise dramatically – by two or three-fold – within the next few years. Precision continues to earn higher returns on its sales and invested capital than its competitors and has a storied history of greatly improving the profitability of its acquisitions. Lead by highly regarded CEO Mark Donegan, during the next few years Precision looks forward to spending several billion dollars on new acquisitions that will continuously help to improve the company's technological progress and suite of products.

Despite being a higher quality business than its peers, Precision's shares are now valued similarly to its competitors and below that of the overall market. Management has taken notice: it is using a greater portion of the company's prodigious cash flow plus a recent debt offering to boost its stock buyback program by more than $2 billion (it expects to continue buying a considerable number of its shares in the near-term). Warren Buffett advises investors to purchase stakes in high quality companies at fair prices. We believe Precision Castparts is such a 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.

NOTES

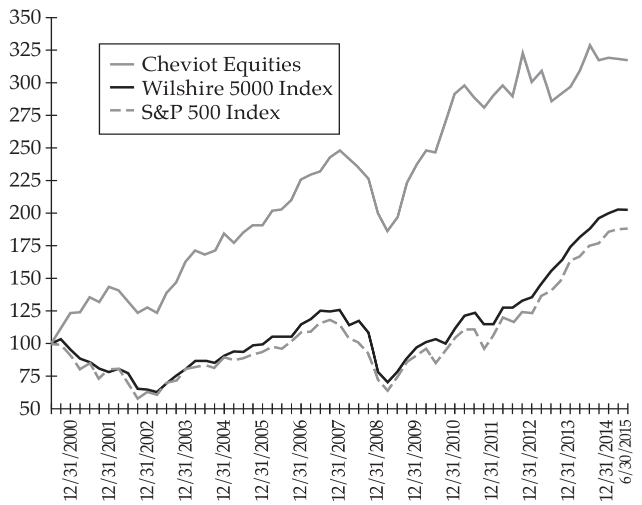
[1]The longevity of Irving and his siblings was extensively studied. The quartet was profiled in a 2011 story in The Wall Street Journal titled "In the Science of Aging, Oldest New Yorkers Hold the Key." Irving's siblings Leonore, Peter, and Helen lived to the ages of 102, 103, and 109, respectively. The study found that some individuals do truly have "good genes," which in this case provide higher levels of HDL (the "good cholesterol"), a less active thyroid (which slows metabolism), and a particular mutation in one's growth hormones which may stave off diseases later in life. Irving said he has no secret for living as long as he did. "Just nature's way." We're not sure what role was played by Helen's strong affinity for rare hamburgers.

[2]This echoes another wise recommendation of Ben Graham: "The market is there to serve you, not guide you."

Cheviot Value Management, LLC

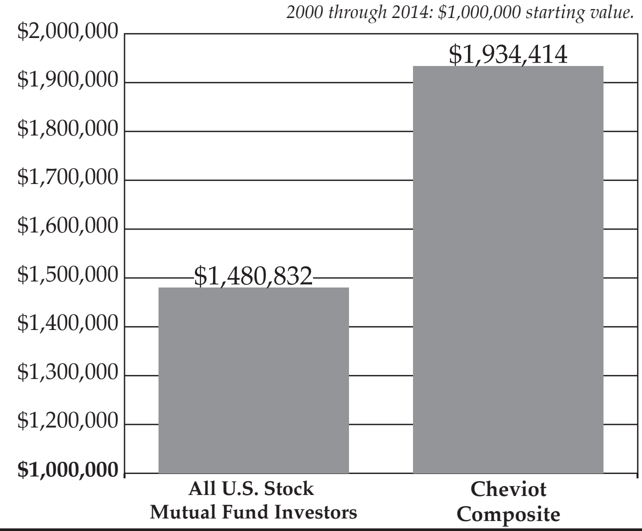
Investment Management • Retirement Planning • Taxation Mitigation • Charitable Giving
Estate Planning • Insurance Advice • Risk Management • Retirement Benefits

Cheviot Equities Long-Term Performance



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

2000 through 2014: $1,000,000 starting value.



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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