

INVESTMENT VALUES

Issue Number 124, October 2017

“The less prudence with which others conduct their affairs, the greater prudence with which we should conduct our own affairs.” - Warren Buffett

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OUR INVESTMENT OUTLOOK

Financial market prices continued their ascent and individual investors, the group that is notorious for being late to the party, are participating in far greater numbers than before.

During this past summer period, Charles Schwab & Co. opened more accounts for individuals to invest their own money than they have at any time during the last 17 years. This reminds us of the peak of the stock market mania in 2000 when individuals thought investing was effortless and a cinch to be profitable. Before long, those investors paid a huge price in the form of a historic market decline.

Schwab management stated during its July conference call: “New accounts are at levels we have not seen since the Internet boom of the late ‘90s... Now it’s clear that clients are highly engaged in the markets. We have cash being aggressively invested in the equity market as the market has climbed.”

This is not a Schwab-specific phenomenon. The American Association of Individual Investors (AAII) reports the most bullish investor positioning since the peak of the 2000 market. (If you’re reading this, you already know that market peaks are always the

worst time to be bullish.) Morgan Stanley stated that cash in its clients’ accounts is at its lowest levels.

It is not just individuals behaving more aggressively. Data released by Merrill Lynch show that its clients’ portfolios, managed professionally, hold less cash now than any other time since 2005. In other words, today – *after* the second longest bull market for stocks in more than a century – they are positioning their portfolios more aggressively than any other time during the prior dozen years with the hopes of higher future market prices.

See the Merrill Lynch cash graph on page 2. On balance, as stock prices crashed in 2008, investors sold shares, raising their cash level. Thus, these investors held more cash at a time when Warren Buffett was using his cash to acquire bargains. Had those investors instead simply stuck to a simple rebalancing of their portfolios – selling some shares when prices rise and buying them when they fall – the cash level would have remained constant during that entire period and their investment performance would have been far superior. Normal human emotions make such rational behavior very difficult to execute.

Warren Buffett today, in contrast to those Merrill Lynch investors, is amassing increasing amounts of cash in the coffers at Berkshire Hathaway. Higher market prices produce a lack of worthwhile investment opportunities. Yet professional and individual investors with much less experience and knowledge than Mr. Buffett, apparently seeing what he does not, are actively investing their own cash. They might benefit from one of the more famous quotes from

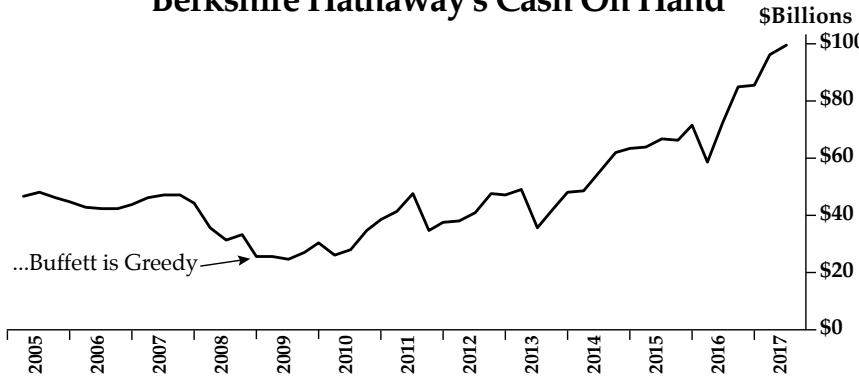
Cheviot is in its 33rd year of serving investment clients throughout the U.S. We deliver personalized investment and financial management expertise to simplify our clients’ complex financial lives. Our firm’s investment objectives are to protect and increase our clients’ wealth through safety-first investing. 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.

Cash Allocation for Merrill Lynch Client Portfolios



Berkshire Hathaway's Cash On Hand



the "Oracle of Omaha" – "Be fearful when others are greedy and greedy when others are fearful."

We agree with Mr. Buffett. While we are not fearful yet, we see evidence of increasing levels of greed in the stock market. High prices are allowing us to opportunistically reduce our stock holdings, positioning our portfolios for the inevitable availability of high-quality bargains. It is a process that runs counter to one's emotions but has served us well over time.

FINANCIAL PLANNING CONSIDERATIONS BEFORE YEAR-END

In addition to investment management, we frequently help our clients with other important areas of their financial lives. These matters include estate planning, charitable giving, insurance advice, and more. Some of our clients have asked that we periodically write a few recommendations in this letter. But, because financial planning is personal and specific, there is no way in a letter like this to target the needs of a group comprising diverse individuals. That said, there are year-end strate-

gies applicable to a great percentage of individuals, particularly in regards to taxation mitigation.

The White House has recently proposed sweeping changes to the tax system. If passed, these changes would likely result in lower taxes for individuals and many businesses. Regardless of how the tax code changes, here are a few financial considerations to ponder before December 31st.

Accelerate Deductions Into 2017

Included in the new tax proposal is the potential elimination of some long-standing tax deductions, including the state income tax deduction, medical expense deduction, and others. Therefore, it may be to taxpayers' benefit to pay estimated state taxes and medical expenses before year-end, rather than in 2018.

Delay Realizing Taxable Gains Until 2018

Currently, there is a 3.8% surtax on net investment income reported by the highest income earners, in addition to a 20% long-term capital gain tax. The GOP's new tax proposals include eliminating this surtax. Accordingly, and if possible, it may be wise *not* to realize gains until 2018, when tax rates could conceivably be only 20%.

Exhaust "Use it or Lose it" Flex Spending Accounts (FSA)

Workplace health benefits frequently offer a tax-advantaged flex spending account from which employees can use tax-deductible funds to pay for medical costs not covered by insurance for themselves or their dependents. Think co-pays on doctor visits and prescription drug medication. However, some plans stipulate that the employee must use all of the funds in the account by December 31st or those funds will be forfeited. Consider a teeth cleaning, stocking up on contact lenses solution, or repairing/replacing eye glasses – all of which qualify for FSA expenditures.

Fully Fund Health Savings Accounts (HSA)

Tax payers, especially business owners and self-employed individuals, who possess high-deductible health insurance policies are eligible to open and fund Health Savings Accounts (HSA). Contributions are tax-deductible, and as long the funds are used for qualifying health costs, withdrawals are tax-free. Accordingly, eligible taxpayers would be well-served to contribute the statutory maximum to these savings vehicles.

Harvest Capital Losses Against Taxable Gains

At Cheviot, we do not advocate allowing taxes to dictate investment strategy. However, when we do realize capital gains, we will examine opportunities in the portfolio to realize equivalent capital losses. By selling securities at a loss, investors can offset securities sold at a gain, resulting in substantial tax savings. For example, an investor in the highest tax bracket who sells a stock for a gain within one year of having purchased it will owe roughly 50% of that gain in federal taxes, including the Medicare surtax, and state taxes. But by selling an equivalent amount of a losing stock, the investor can eradicate the gain and have a resulting tax bill of \$0.

If capital losses exceed capital gains for the year, up to \$3,000 of those realized losses can be used to offset ordinary income (or \$1,500 for married taxpayers who file separately). The remainder can be carried forward to offset gains in future years.

Make Annual Gifts to Family (or Others)

In 2017, taxpayers are permitted to gift up to \$14,000 to as many individuals as they like without reducing their lifetime gift and estate tax exemption. The gift is tax-free to the recipient, and while not tax-deductible to the donor, the funds reduce the donor's estate and subsequent estate taxes at death. No gift tax return is required to be filed for gifts that do not exceed \$14,000.

Take Required Minimum Distribution (RMD)

After age 70½, one must take minimum distributions from traditional IRAs (including rollover and SEP-IRAs) and 401(k) accounts (in most cases). Failure to take the required minimum distribution by December 31st could subject investors to penalties

as high as 50% of the undistributed amount.

Make Charitable Gifts

Most gifts to qualified charities are tax-deductible. Donating before year-end allows the tax payer to deduct the donated amount in the year of the gift. Rather than donating cash, consider donating securities that have appreciated. By donating shares of highly appreciated stock, for example, the donor receives a deduction in the amount of the full fair market value of the security as of the date of donation. This has the dual benefit of avoiding capital gains tax and preserving cash that would otherwise have been donated. Additionally, the same amount of shares that were donated could also then be purchased with a new – and tax-friendly, higher – cost basis.

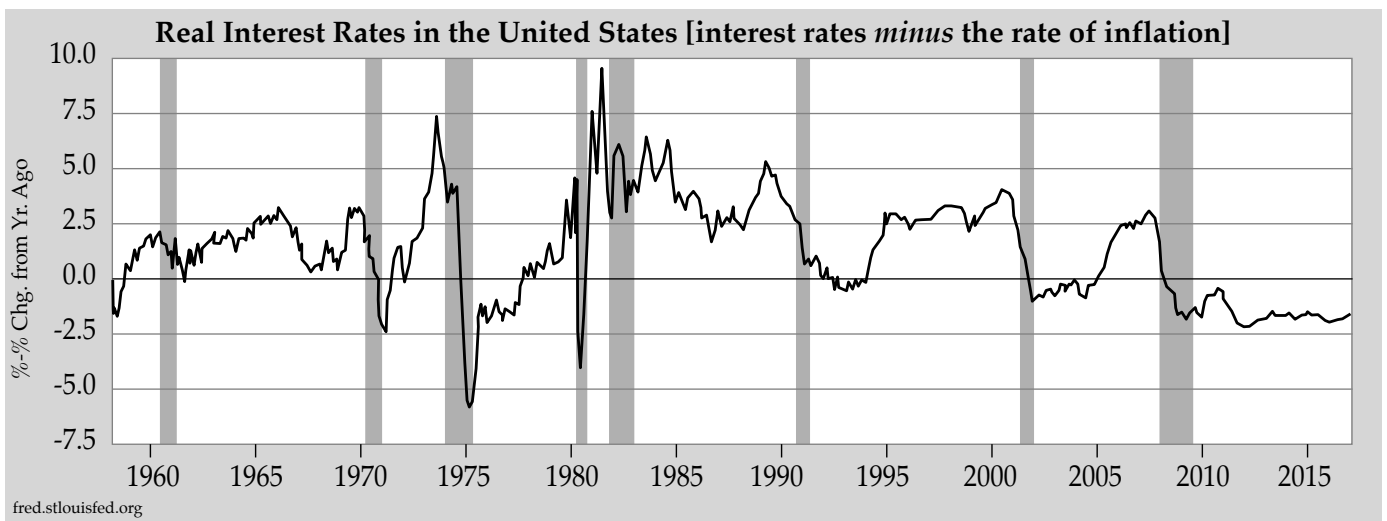
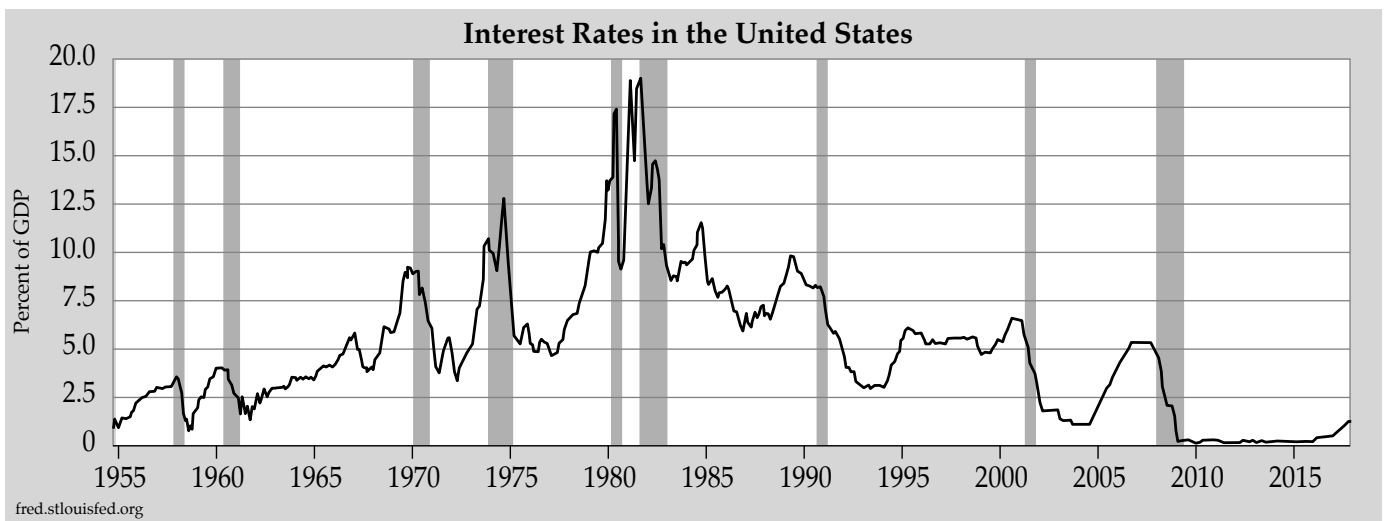
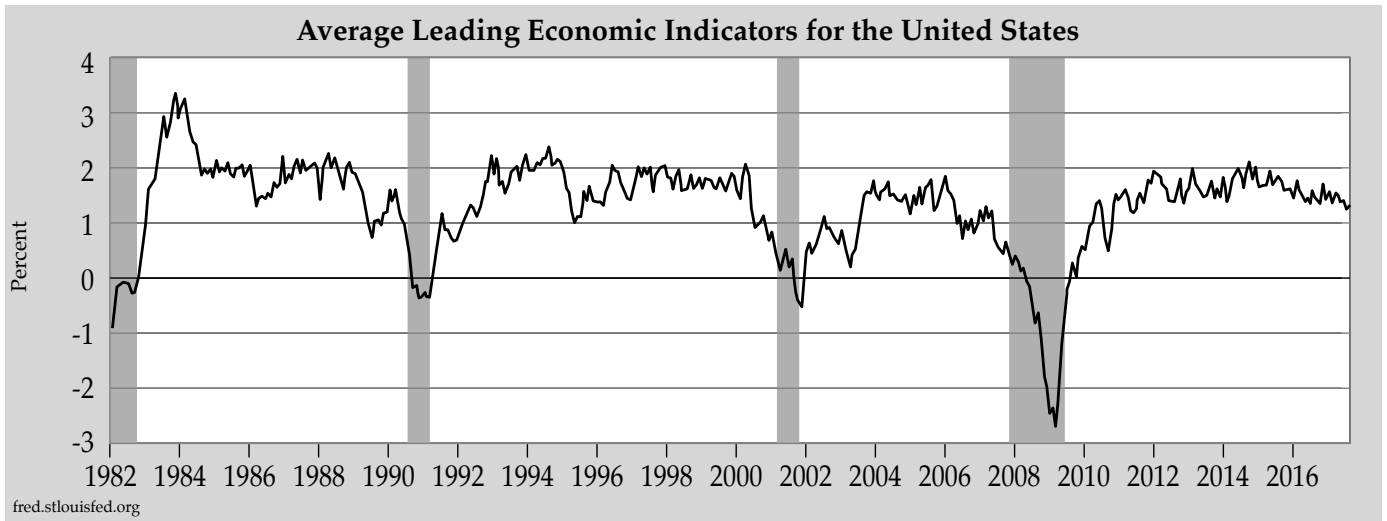
As an alternative to donating directly to a charity or to multiple charities, donors can establish and donate to a Donor-Advised Fund (DAF). This fund acts as a repository for donated assets to be distributed to qualified charities at a later time. The donor receives a tax deduction for the full amount

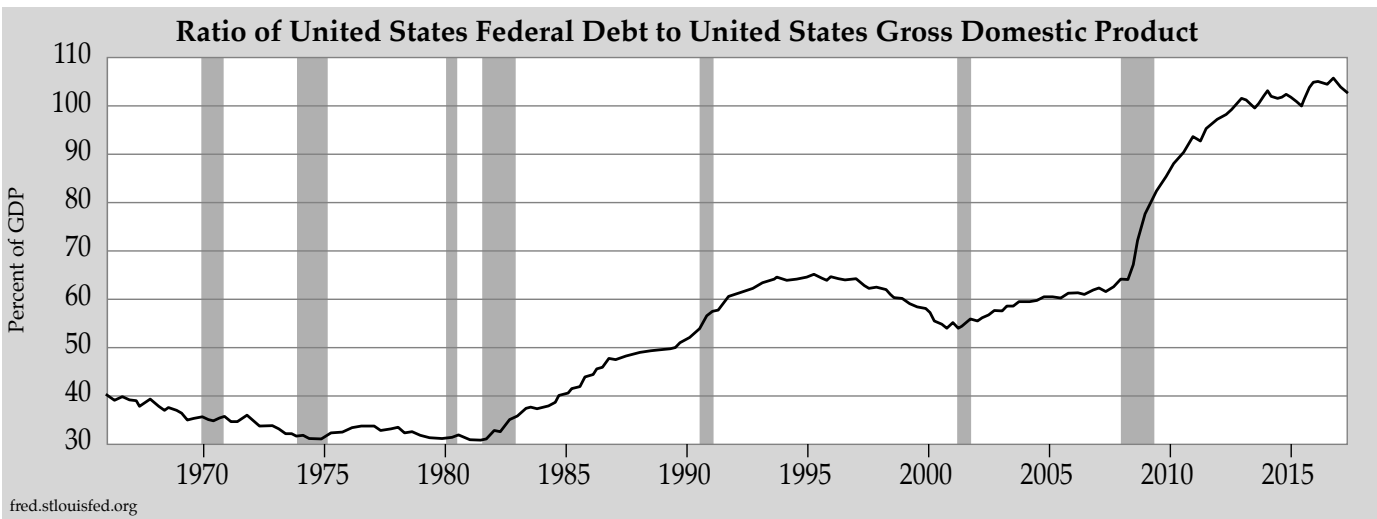
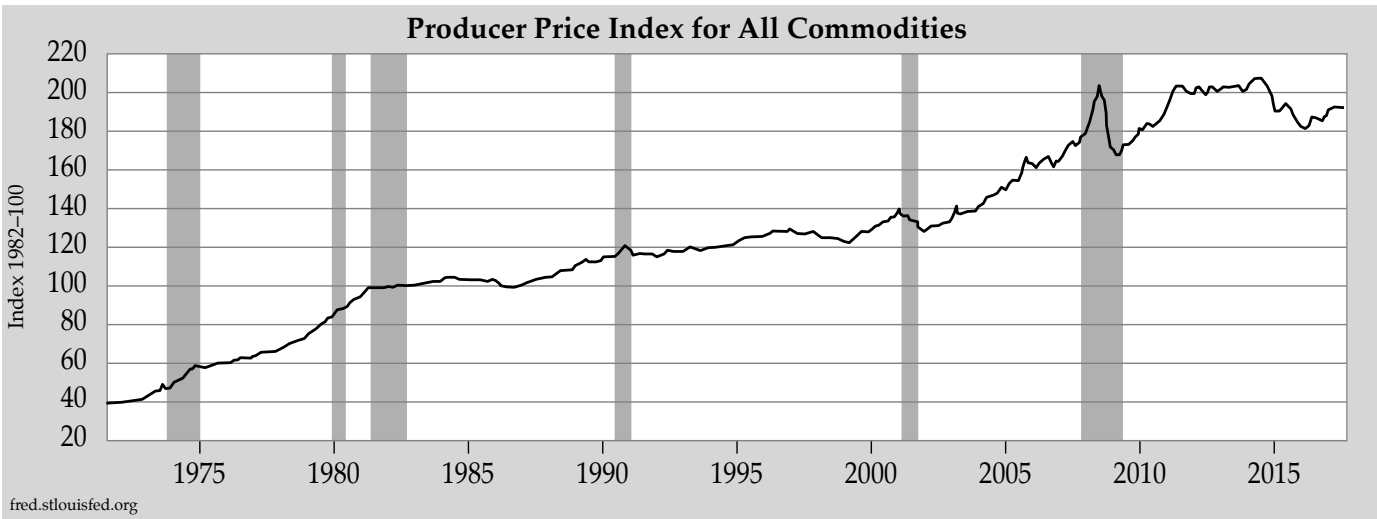
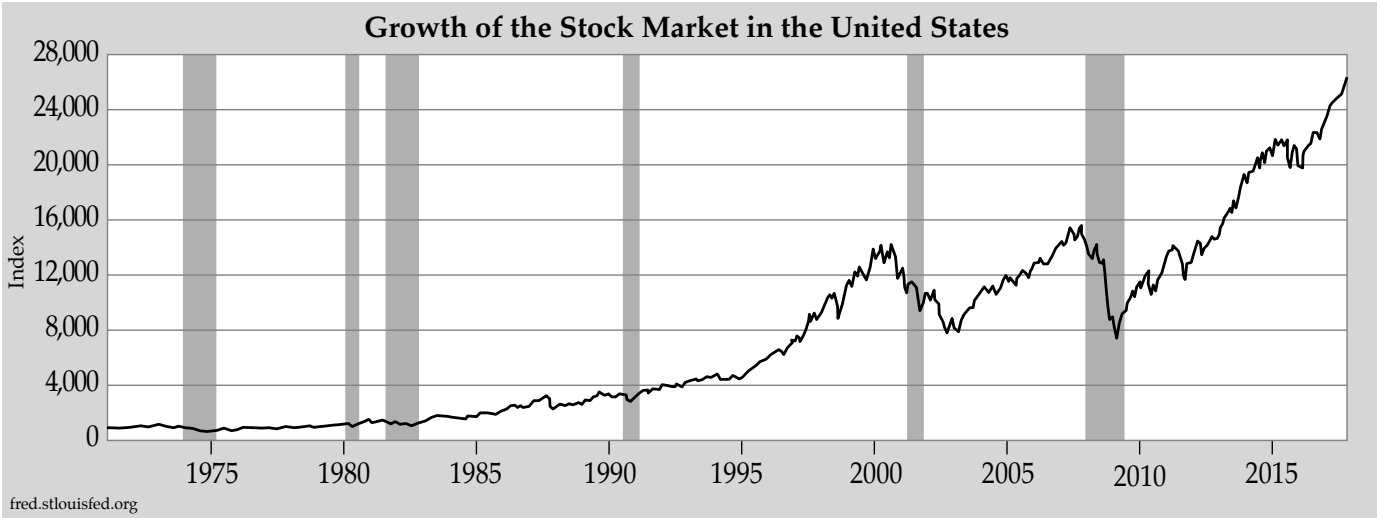
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...We share a small sample of graphs that we believe paint a broad picture of U.S. economic activity and sentiment. Graph 1, Average Leading Economic Indicators, compiles ten important economic data points, including those related to manufacturing, employment, and consumer sentiment. Graph 2, Interest Rates in the U.S., illustrates the peaks and valleys of short-term interest rates over time. Graph 3, Real Interest Rates in the U.S., depicts the level of short-term interest rates adjusted for (or after) inflation. Graph 4, Growth of the Stock Market in the U.S., portrays the long-term increase in U.S. stock prices and often reflects sentiment toward the economy. Graph 5, Producer Price Index for All Commodities, shows the long-term march higher and periodic setbacks in price for a compilation of various commodities used throughout the U.S. and the world. Graph 6, Ratio of U.S. Federal Debt to U.S. Gross Domestic Product, describes the level of U.S. Government debt relative to the size of the U.S. economy.

Cheviot's Graphical Interlude: Charting the Progress of the U.S. Economy and Financial Markets





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donated to the DAF in the year of donation, even if the DAF distributes the funds over a period of years.

Open a Solo 401(k)

Self-employed individuals can take advantage of increased contribution limits by sheltering income in a qualified retirement plan, like a solo 401(k). Furthermore, spouses who are on the payroll may also contribute to the plan. Including what is termed “catch-up contributions” for participants age 50 and over, a husband-wife team can shelter up to \$120,000 between them in 2017, provided earned income from the business for each is at least \$60,000.

There are other year-end strategies that individuals can employ; the aforementioned are just a few. We are happy to discuss any of these with you.

MODEL PORTFOLIO UPDATE

Despite an elevated market for stocks (bonds and real estate, too), we made one new stock acquisition in the past quarter. For the past couple of decades, and until recently, we have been bearish on the fortunes of General Electric (GE). This proved worthwhile as the shares fell from a high north of \$60 in 2000 and recently dipped below the mid-\$20s this past summer. During the summer months, we turned bullish on GE’s future and initiated a position in the company’s shares.

GE traces its roots to the 1880s and businesses that were founded by Thomas Edison. Near the turn of the century, the company’s shares joined those of 11 other corporations in forming the Dow Jones Industrial Average. The “Dow,” which now comprises the shares of 30 companies, counts GE as the only original member to still be in this stock market index.

GE is an industrial conglomerate that includes business operations in various industries including aviation, energy, oil and gas, lighting, transportation and healthcare. In June of this year, GE’s Board of Directors appointed a new CEO, John Flannery, to run the sprawling organization.

During the last several years, GE has routinely set expectations too high for its shareholders only to later disappoint them. Such overpromising and underdelivering is why its shares recently plumbed

52-week lows and are well below highs set not just in prior years but prior decades. Today, we see the potential for a company-wide turnaround and insiders agree as they are buying shares as this unfolds.

GE is more streamlined than it was just a few years ago. The company received considerable value for its divestitures of parts of GE Capital which was, in 2015, equivalent to the seventh largest bank in the U.S. It also favorably spun off Synchrony Financial and used the proceeds to repurchase GE shares. And the company’s other recent deals have been positive: GE merged its oil and gas businesses with Baker Hughes, creating a tech-savvy giant in the industry. In 2015, the company acquired the power-equipment business from the French conglomerate Alstom. This deal, spearheaded by GE’s newly-appointed CEO, was widely panned at the time. But in buying a relatively unloved asset the company paid a relatively attractive price. Furthermore, the company has since reaped synergies of \$1.5 billion in its first year under the GE banner as compared to a 5-year expectation of \$3 billion that Wall Street thought in 2015 was unlikely.

GE’s new CEO, John Flannery, has a track record of success within GE, most recently improving GE’s healthcare division. Prior to that Flannery spent time evaluating mergers and acquisitions, he worked to reduce GE Capital, and he oversaw divisions in India and Latin America during his 30 years with the company. Since being appointed CEO, Flannery has made clear a sense of urgency regarding his expectations for improving the conglomerate’s fortunes. He has already begun to cut costs and finalize a deal to sell one of GE’s industrial divisions.

In early June, GE shares jumped to nearly \$29 on the news of John Flannery’s appointment to CEO. The more than 20% decline in the share price since then provides what we think is an intelligent opportunity for the long-term, patient investor. And this includes that of several GE insiders: insider purchases are both recent and widespread at recent price levels. Five insiders purchased shares around the time of our acquisition. The insider purchases include nearly \$2.7 million worth by the incoming CEO and another \$2.5 million worth by Board member and well-known investor James Tisch.

Shareholders also have on their side the successful activist investor Nelson Peltz and his firm's more than \$1.7 billion stake in GE.

Given the company's history, shorter-term investors are justified in their skepticism about any decision made by GE's Board and Flannery's ability to improve the company's operations. But we believe the new CEO gives shareholders a capable leader to further streamline GE. To us, recent stock sales by shorter-term investors create the opportunity for longer-term investors to seek future gains as new leadership makes its mark.

CREDITS

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

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Cheviot Value Management, LLC's new account minimum balance is \$1,000,000. Client assets are allocated principally among the following asset classes: equities (common stocks), fixed income (bonds) and money market funds ("cash").

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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.

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CHEVIOT VALUE MANAGEMENT, LLC

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

Today, Cheviot Value Management is one of the oldest independent investment advisors in Los Angeles. Its founder, Frederic G. Marks, was an experienced business attorney with a bird's eye view of the struggles his clients faced when investing their hard-earned savings. Repeatedly, he witnessed his clients incurring losses or being mistreated – sometimes without knowing it – by financial services professionals. Since its founding in 1985, Cheviot's mission is to provide financial peace of mind through careful investing and thoughtful financial advice. Unlike what Fred witnessed elsewhere in the financial services industry for so many years, his goal for Cheviot was to put the interest of the client ahead of all else. *Just be helpful.*

We begin, in Fred's words, by helping clients avoid "uninformed speculation under the guise of investment." Based on the teachings of legendary investors Benjamin Graham, his most famous student Warren Buffett, and his business partner, Charles Munger, Cheviot seeks to own high quality investments for its clients (and members of the firm right alongside them). Our approach aims to produce a more stable growth trajectory, with less volatility than occurs in the stock market. This helps our investors sleep well at night and enjoy greater long-term success.

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*, *Bloomberg*, *The Wall Street Journal*, *Money Magazine*, *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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