Cheviot Value Management, LLC

Investment Values

Issue Number 122, April 2017

"If history repeats itself, and the unexpected always happens, how incapable must man be of learning from experience?" - George Bernard Shaw

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OUR INVESTMENT OUTLOOK

Throughout the first quarter, confidence was in complete control across the U.S. economy and financial markets.

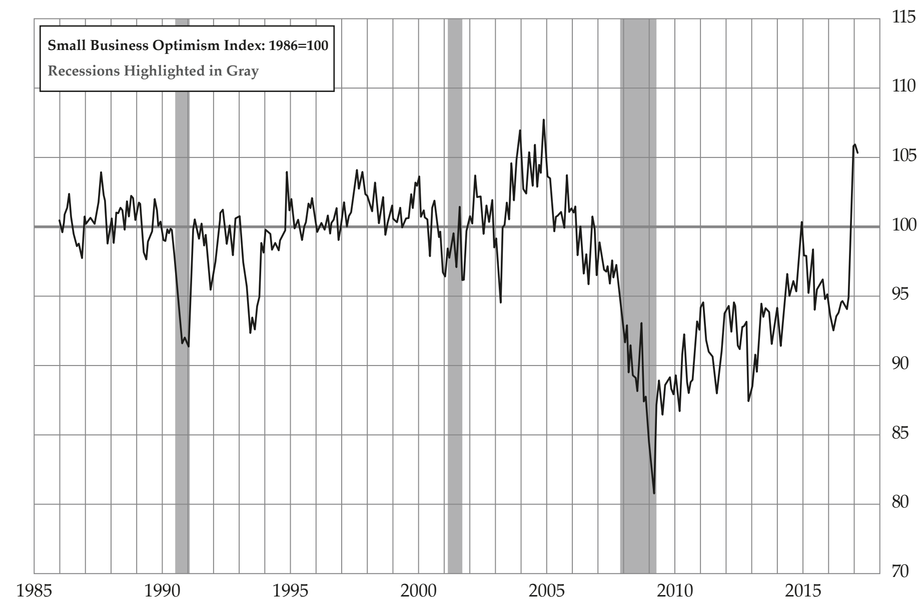
The National Federation of Independent Business conducts a monthly sentiment survey within the U.S. In recent months, optimism has soared. (See nearby graph.) Reflecting more positive views of current business, labor, and income prospects, U.S. consumer confidence in March soared to heights last reached in the year 2000. Increasing optimism throughout the economy has greatly reduced the near-term likelihood of a domestic recession. Hopes abound for the U.S. economy to generate greater than the lackluster growth of the recent past.

With market participants hopeful for stronger U.S. economic activity ahead, prices of financial assets continued their post-election climb. On balance, those on both Wall Street and Main Street expect a brighter economic future. (Often, there is a reflexive component to this as optimism on Wall Street pushes stock prices higher which cause people on Main Street to become more optimistic – and then the cycle continues. While they occur, positive feedback loops such as these are certainly more enjoyable than negative ones!)

Something happened recently in the markets that has not occurred since January, 1987: the Dow Jones Industrial Average ("the Dow") rose to new highs on 12 consecutive days. Then, a very short time later, something happened for the first time since the 1970s: when the White House could not pass a new healthcare bill, the market declined on eight consecutive days. Given the dramatic change

Confidence in Command: Small Business Optimism Index Surges Higher

dshort.com, March 2017



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.

in the landscape for government policy, markets are taking their cues to move higher or lower based on the potential for successful pro-business government policy emanating from Washington D.C.

While the stock market retreated somewhat in those eight declining days, it remains elevated on a valuation basis. Since November stock prices rose on the belief that beneficial legislation would both surely and effectively be passed into law. Now, given higher prices, pro-growth policy must be enacted forcefully and without considerable delay to justify current market levels.

We would not be surprised to see market participants begin to take a more balanced look at the potential for such policy not to arrive as hoped. The failed first attempt at passing healthcare reform shows the difficulty of enacting new legislation. Tax reform may be weaker and arrive later than expected (Treasury Secretary Steve Mnuchin says he will push for this to occur before Congress's August recess though he believes it is unlikely to be passed by then). Infrastructure spending, unlike what voters expected in November 2016, appears to be a topic more likely enacted in 2018. International trade ideas are particularly controversial and, if eventually enacted, are likely to be highly disruptive. At times, the market has overlooked these scenarios.

Market participants would be wise not to expect the "Trump bump" to occur indefinitely. Market prices do not move in straight lines. We are reminded of the market's rise in the wake of Ronald Reagan's 1980 election. A pro-business policy shift was to begin. Stock prices quickly rose by 10% in the weeks following the 1980 election but, within the next two years, the market fell by nearly 30% before embarking on a longer-term bull market.

Some facts today would augur more bullish for market prices, *e.g.*, today's Federal Reserve is more gentle toward the markets than the Federal Reserve of the early 1980s – and others would augur more bearish for market prices, *e.g.*, today's market valuations are dramatically higher than they were in the 1980-1982 period. So, while not all past details serve as prologue, there are a number of present-day parallels. History may not repeat, and in this case it may rhyme less than simply offer good prose for thought. As investors, we believe it is wise today to be balanced and flexible. Confidence and optimism are nice to have on our side (people will wonder where they went in the next market hiccup) but eventually market participants will demand results. Nobody can predict the timing of such a demand, but we expect it will pay to be prepared when it occurs.

THE PERILS OF WHAT'S POPULAR

At this time, we place an unusually high probability on the occurrence that, at some time in the next few years, investors in index funds will see their investments suffer drastically. Just as in prior market cycles, a great many of those investors will succumb to the pain of lower portfolio values and then will sell. The process will be the mirror opposite of that which has occurred in the last few years as higher prices caused investors to buy more stocks at ever-higher valuations.

"The four most dangerous words in investing are 'this time it's different.'" – Sir John Templeton

Whereas doing what's popular in many parts of life can be fun, in investing, what is most popular often becomes what is most dangerous. Attracted by a rising price, countless investors will pour money into an asset class (for example, real estate or stocks in general) or a particular stock (shares of a currently high-flying company with a product temporarily in vogue). Much of the general public, commonly known for being late to arrive at a financial market party, becomes confident enough to join in. Thus, with investing, too, doing what is popular is also fun, at least for a while.

But buying along with the stampeding herd is no way to secure a good price (and a satisfactory future return) for an investment. Says Warren Buffett: "Most people get interested in stocks when everyone else is. The time to get interested is when no one else is. You can't buy what is popular and do well."

Today's most popular investment endeavor is to plow money into index funds. An index fund is a mutual fund or exchange traded fund ("ETF") whose holdings are constructed to hold the same shares and in the same proportion as a particular stock market index. For example, an index fund can be constructed to match the holdings, and therefore closely match the price movements, of an index such as the Dow Jones Industrial Average, the S&P 500 or the Wilshire 5000. Each of these funds would include the shares of 30, 500 and 3618 different companies, respectively.[1] [See Notes on Page 7.]

Owning shares of an index fund is referred to as a "passive" approach to investing. Owning shares directly and in a way that does not mimic a particular index is referred to as an "active" approach to investing. Because passive funds require little management, their fees are generally less.

Another crucial difference between active and passive funds is that active funds need not be 100% invested in the securities that are held in their benchmark. On the other hand, passive funds must be identically invested in the index in which they are supposed to mimic. Index funds must be fully invested. If stock prices are high and bargains are scarce, active investors are allowed to be less than fully invested. Active funds can hold cash and bonds in their portfolios (and in large amounts, too). Active investors can take defensive measures when the investment landscape is unsafe.

Due to their fully-invested nature, the bull market for stocks caused stock index funds to perform well. They are now routinely touted as providing better long-term results than actively managed funds.

But there is one striking fallacy to the claim that index funds are an investor's panacea: professional and individual buyers of index funds suffer far worse performance than the funds themselves. This is because buyers of funds all too often purchase them when prices are high and sell them when prices are low. After all, buyers of these funds are human beings falling prey to their untamed emotions of fear and greed.

Here is proof that you will never see in any advertisement about index funds: the actual investment return to all individuals from owning the S&P 500 is less than *one-half* the performance of the S&P 500. As Buffett says, "You can't buy what is popular and do well."

The average total return for long-time Cheviot clients during this time span exceeds both of the above.

Total Return of an Index Fund - *and Its Investors* - Since 2000

Vanguard 500 Index	Investors' *Actual* Performance in Vanguard 500 Index
110%	49%

Investors in "passive" funds are making an active choice to buy an index fund, then an active decision to continue to hold it, then another active decision when they sell it. Human emotions are integral to this supposedly "passive" approach.

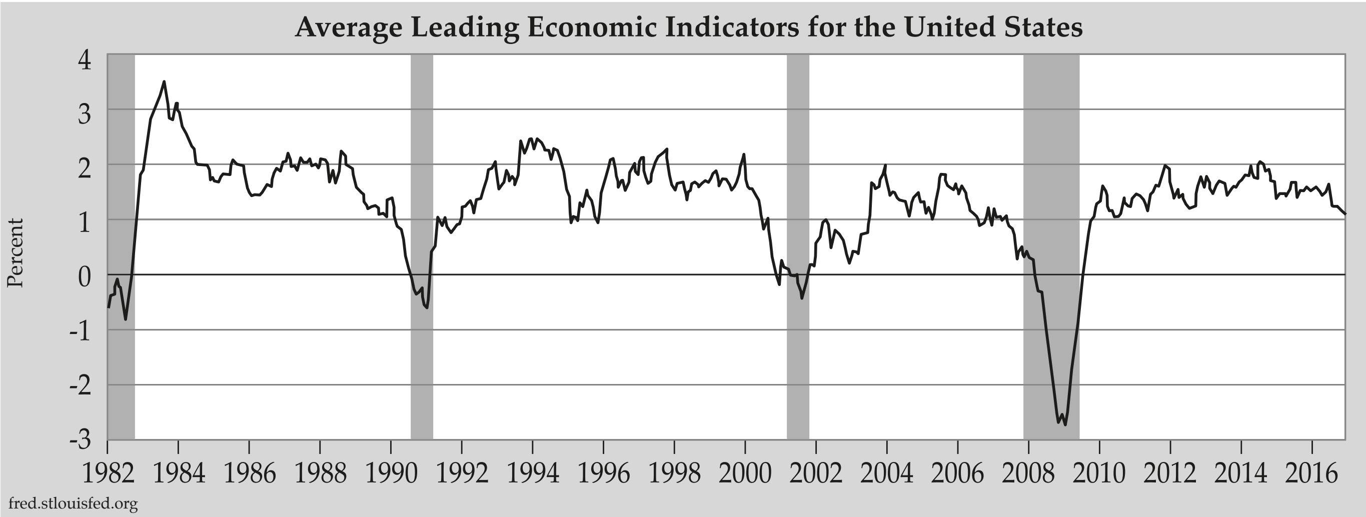
"We learn from history that we do not learn from history." – Georg Wilhelm Friedrich Hegel

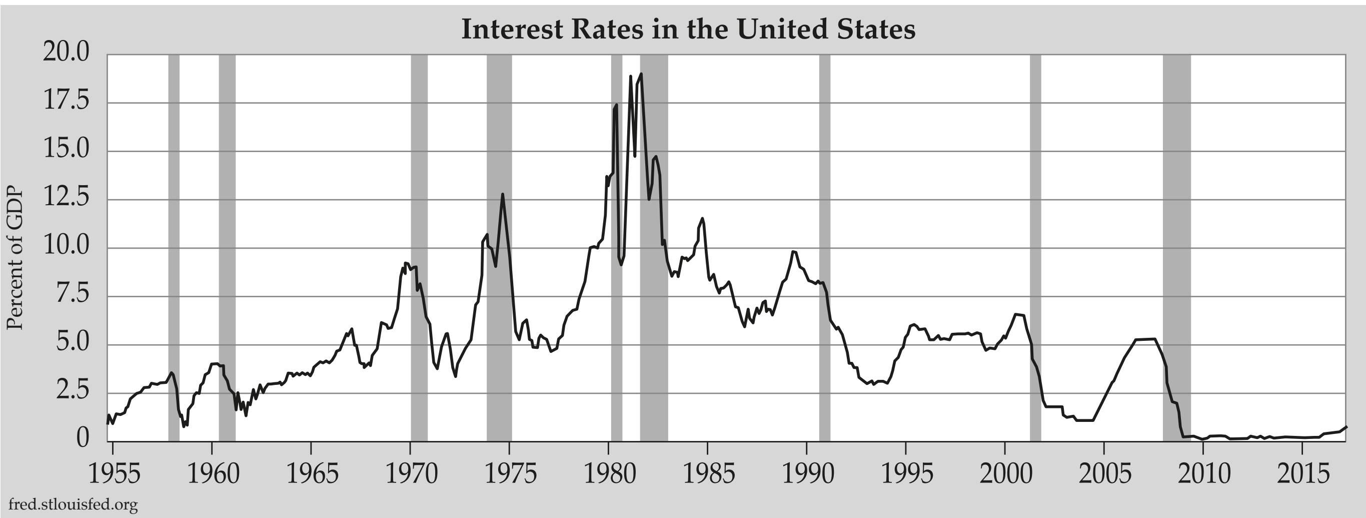
We all know by now that investors commonly buy enthusiastically at high prices yet panic and withdraw funds at low prices. What fascinates us is the cyclical nature by which index funds become popular. *– Article Continues on Page 6*

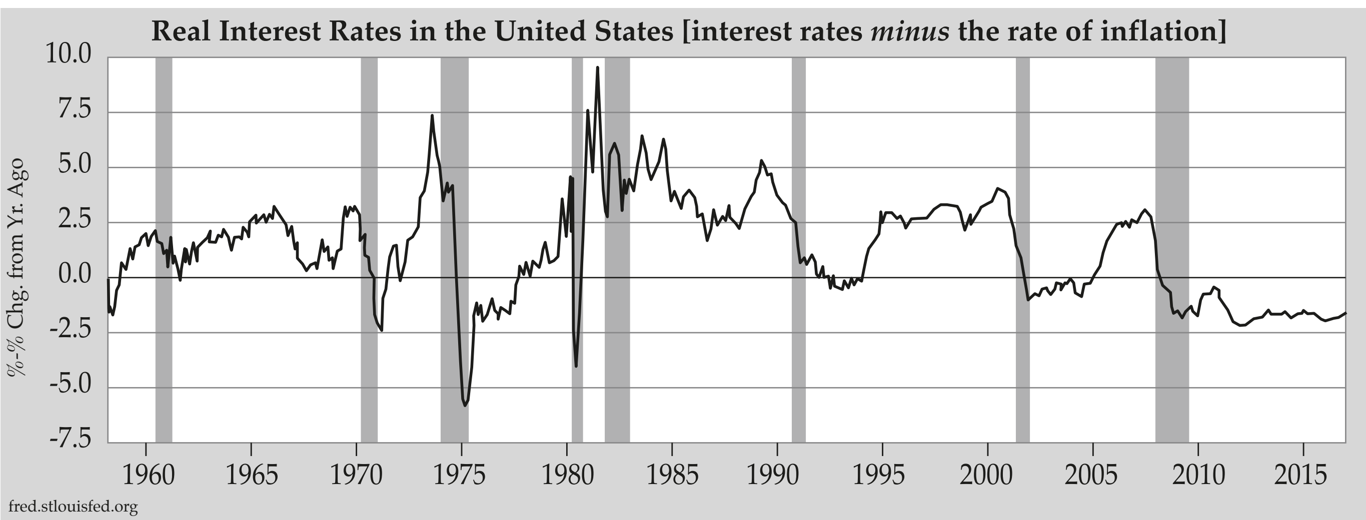
ON THE NEXT TWO PAGES…

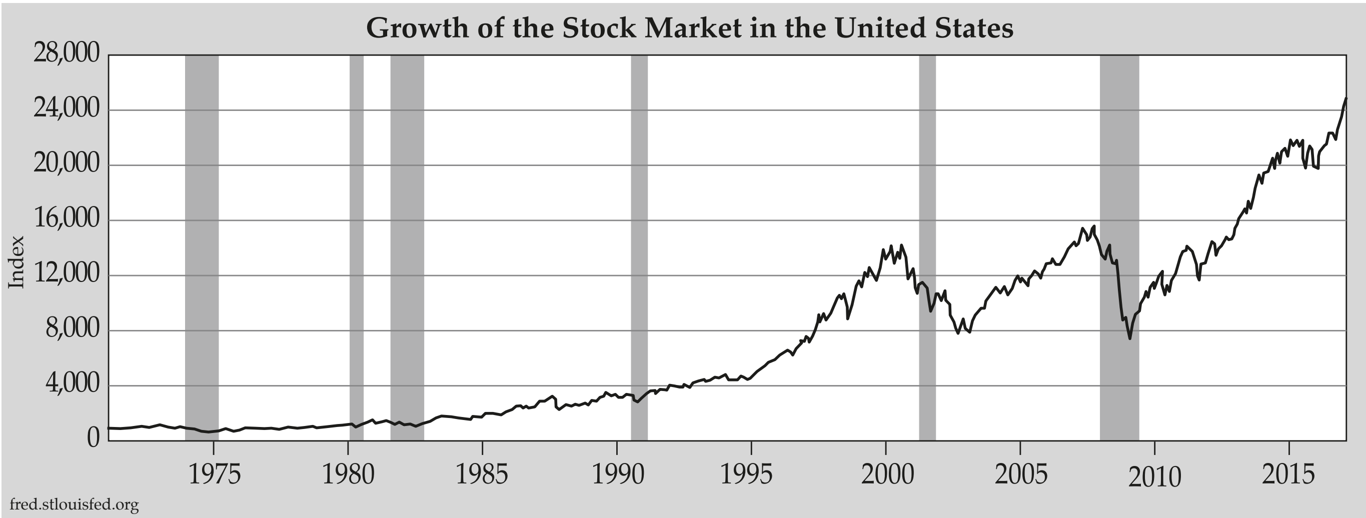
…We share a small sample of graphs that we believe paint a broad picture of U.S. economic activity and sentiment. Graph 1, Average Leading Economic Indicators, compiles ten important economic data points, including those related to manufacturing, employment, and consumer sentiment. Graph 2, Interest 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.

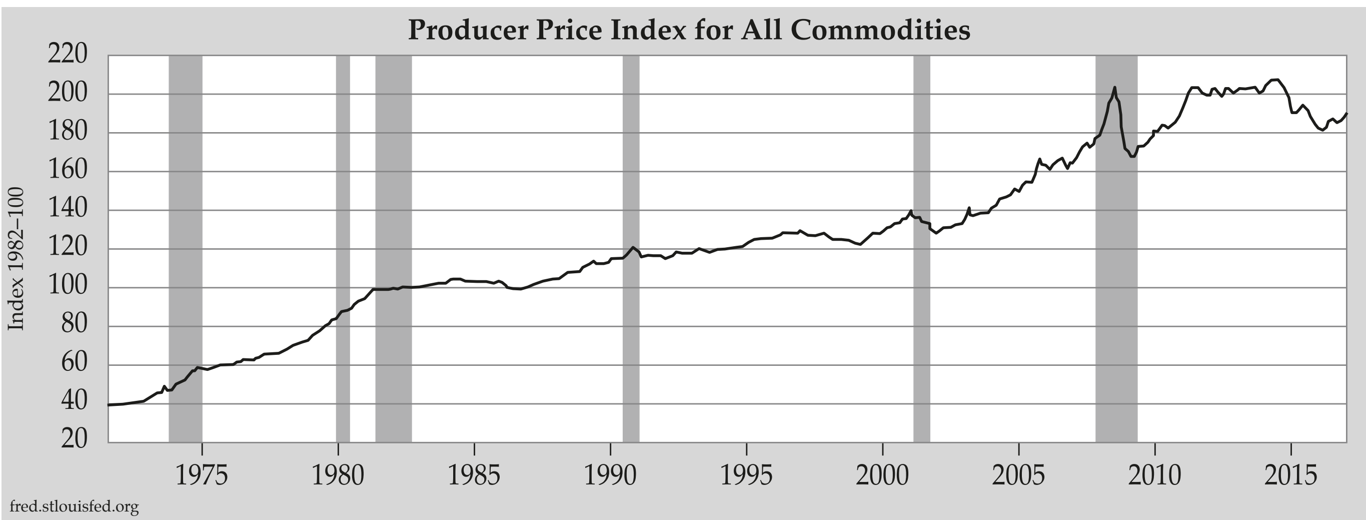
Cheviot's Graphical Interlude: Charting the Progress of the U.S. Economy and Financial Markets

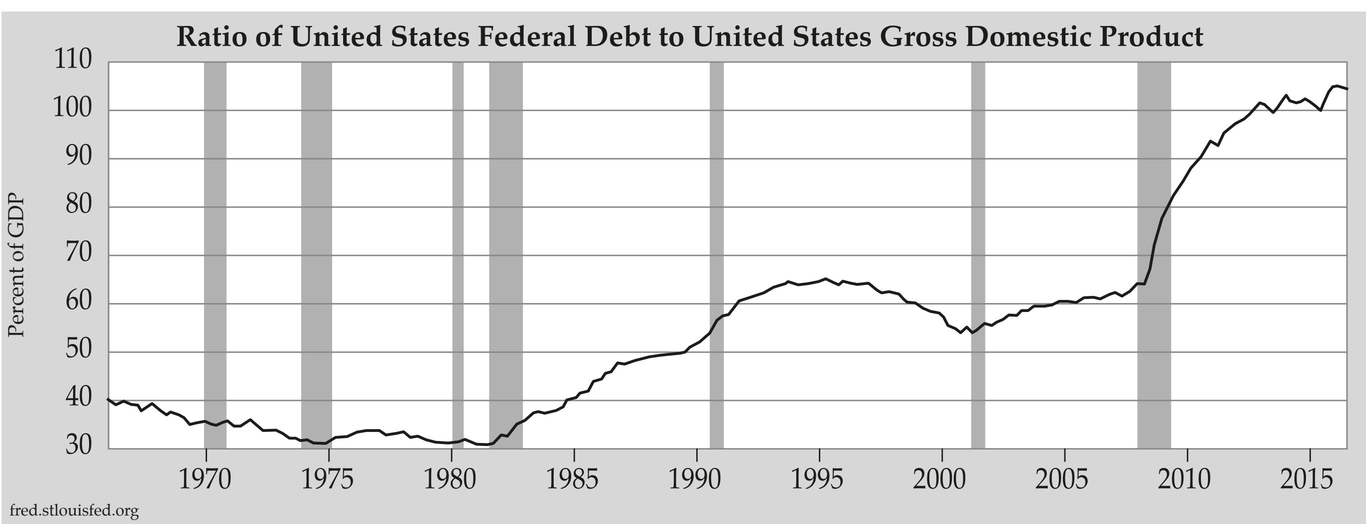







Growth of the Stock Market in the United States
28,000
24,000
20,000
16,000
12,000
8,000
4,000
0
Index
1975
1980
1985
1990
1995
2000
2005
2010
2015
fred.stlouisfed.org


Producer Price Index for All Commodities
220
200
180
160
140
120
100
80
60
40
20
Index 1982–100
1975
1980
1985
1990
1995
2000
2005
2010
2015
fred.stlouisfed.org


Ratio of United States Federal Debt to United States Gross Domestic Product
110
100
90
80
70
60
50
40
30
Percent of GDP
1970
1975
1980
1985
1990
1995
2000
2005
2010
2015
fred.stlouisfed.org

– Continued from Page 3

The raging bull market of the late 1990s propelled investors to increase flows dramatically into index funds. The value of assets held in index funds thus ballooned ten-fold, from less than $50 billion to nearly $500 billion in just a few years. BusinessWeek, sounding like so many other publications, posed the headline, "Who Needs a Money Manager?"

Recall that equity index funds hold no cash or bonds. They are fully invested at all times. Index funds are tied to every market gyration. In short, they are the market itself. And when the market is rising, greed takes over and investors want to be fully invested to gain the full benefit of rising prices.

The valuations of stock prices were ignored but these are a critical component of one's future investment return. In these pages in 1999, when stock valuations were at unsustainably high levels, we warned readers of the perils facing index fund investors at that time. By 2002, the S&P 500 had fallen 45% from its 2000 peak. The Nasdaq declined by 80%. Professional and lay investors alike who had piled into index funds suffered the full extent of the market's decline. The sword of the index fund had now cut both ways.

In the bull market of 2005 through 2007, investors piled right back in to index funds. "Once burned, twice shy" was replaced with "once burned, *never mind!*"

So, in 2006, we warned: "The important message to glean from the historical performance of stock market indexes is that the *valuation* of the stocks that dominate a market and a market index can make it attractive and profitable – or risky and dangerous. An investor should always require a reasonable price before buying, even when buying an index fund; getting a good price is the key to minimizing the chance of loss while maximizing the chance of success in the stock market, whether one is considering an index fund, a single stock or a collection of individual stocks."

We asked, "Why is it then, in view of such evidence, and much more that could be presented here, that the public is constantly urged to buy into index funds *at any time and any price?*"[2]

Reflecting this, in July 2007 – at the very peak! – *USA Today* ran a headline stating "Owning the S&P 500 is Cheap, Easy, and Smart." Endorsements of index funds were popular throughout much of the financial media as recent prior performance was extrapolated well into the future.

With index fund investing at its second peak of popularity, the stock market then collapsed by more than 50% in less than two years.

Today, the 2008 market crash is firmly in the rearview mirror of investors' minds. Stock prices have marched higher and memories of the prior bear market are another ignored, dust-covered chapter of financial history. Professional and lay investors are pouring unprecedented sums into index funds.

Caution is an anchor, scoffed at in times of a rising stock market.

As in prior manias for index fund investing, investors are discarding any safety nets that active management may provide. They are again tying themselves 100% to the direction of the stock market.

We often read and hear that index funds are more diversified and, therefore, safer investments. *Yet the losses generated by index fund investments are immense.* The one thing an investment in an index fund *guarantees* is that the holder of the index fund will endure *100%* of the loss in value generated by the next bear market. Even when a market is expensive, an index fund must remain fully invested. Therefore, it must then suffer the complete decline of whatever-sized bear market occurs.

"Financial disaster is quickly forgotten...There can be few fields of human endeavor in which history counts for so little as in the world of finance." – John Kenneth Galbraith

Does the investing public know something special this time or is it again leading its portfolios to the slaughterhouse?

Today, stock market *valuations* (not the prices of stocks but prices relative to underlying fundamentals like sales, earnings, book value, etc.) tower above all prior periods except for the largest bubble of all time, 1999-2000. From today's level of valuation, history and experience warn index fund investors to lower their expectations and, better yet, to brace themselves for disappointment. (Those who have the freedom not to be fully invested will, in our opinion, travel far more safely through what may come.)

But this is difficult for the investing masses to fully comprehend when economic data is improving and stock prices are rising. Whenever market valuations reach high levels, there are always throngs of people all too happy to explain why this is so and why it will persist. Happy investors and high prices go hand in hand. (As Buffett famously said, "You pay a high price for a cheery consensus.") Never do you see investors celebrate low prices, a level which produces plentiful bargains and strong future returns. But investors would be well-served to be greedy during those difficult times.

Additionally – and crucially – the investor in index funds gives up a valuable advantage: the ability to be selective. In investing, there is no requirement to own the shares of *all* companies, from the highest quality to the lowest. (Wall Street marketing departments call ownership of large swaths of companies "diversification" whereas master investor Charlie Munger refers to it as "madness.") The intelligent investor is not forced to own the shares that are both overpriced and those that are underpriced. Instead, the discerning investor can focus simply on owning the best companies with a keen eye on price. (After all, buying a great company at too high a price often leads to disappointment.)

Investors who take a balanced approach, owning shares of only the higher quality companies at reasonable prices, should survive future fluctuations with greater results and the ability to take advantage of the selling of others.

CREDITS

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

DISCLOSURES

Founded in 1985, Cheviot Value Management, LLC specializes in providing investment portfolios with the long-term goals of growth of capital and income production over time. Included within the management of a client's investments, Cheviot Value Management, LLC also provides financial planning advice including potential strategies related to tax considerations, estate planning, insurance coverages, philanthropy, and next generation preparation. While not a professional tax or legal advisor, Cheviot Value Management, LLC assumes no liability for any tax or legal advice given. Cheviot Value Management, LLC offers such suggestions with the expectation that they will be further examined by a tax or legal professional.

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").

Investment 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 Value Management, LLC 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.

Cheviot Value Management, LLC may alter its current investment positioning and strategy as market conditions change or are perceived to change. Differing client needs may require the ownership of different investment securities or differing amounts of similar investment securities. Differing client needs may also require the addition or disposition of investment securities according to changing client needs.

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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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NOTES

[1]Yes, the Wilshire 5000 Index actually contains fewer than 3700 companies. There were closer to 5000 companies when the index was formed in 1974. Calling it the "Wilshire 3618" would not be very catchy.

[2]One reason: buying index funds takes little effort on the part of financial advisors and it allows them to spend their time promoting their services to other individuals. Or simply playing golf.

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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