

INVESTMENT VALUES

Issue Number 123, July 2017

*"There are worse situations than drowning in cash and sitting, sitting, sitting.
I remember when I wasn't awash in cash – and I don't want to go back."* - Charlie Munger

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OUR INVESTMENT OUTLOOK

The U.S. economy is in the midst of its third longest recovery (time spent since a recession or depression) in more than a century. Low interest rates and gargantuan other means of financial stimulus by the U.S. Federal Reserve during the past 8-plus years kept the economy afloat while propelling stock prices higher. Now, the Fed is very slowly trying to "normalize" interest rates (return them to non-emergency levels). It raised rates again last month with another 0.25% baby step.

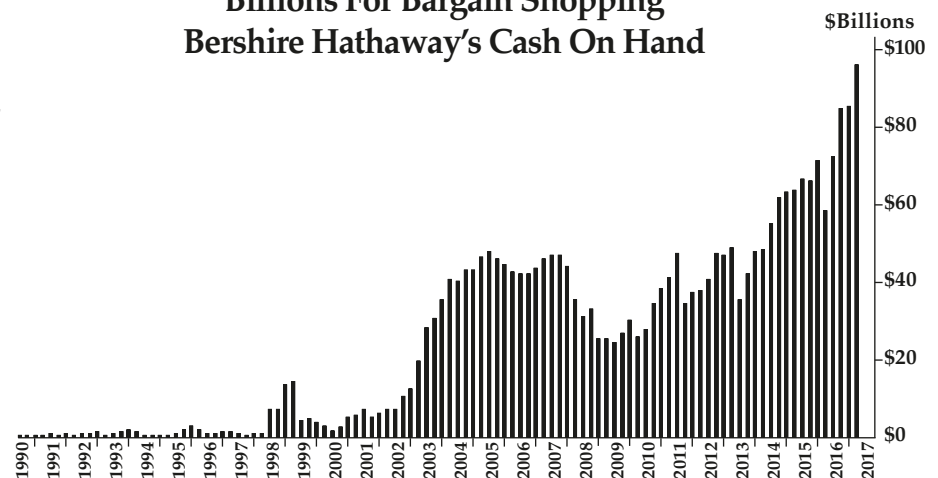
The Fed is very patient with its hiking campaign out of fear of derailing the persistently weak recovery. GDP growth for the year 2016 was a lackluster 1.6%. Hopes for the first half of 2017, as of when we went to print, are currently near 2%. Consumer spending is far from robust, as evidenced by activity in the discretionary industries of retail and restaurants, while the auto industry

is slowing. The strong consumer sentiment and business optimism surveys from year-end 2016 and earlier in 2017 have done little to ignite economic "animal spirits." (This is the phrase, coined by John Maynard Keynes, given to times when optimism strongly fuels economic decisions.) On the bright side, strong sentiment may have staved off a slowing of economic activity while the country awaits – or wishes for – substantial pro-growth fiscal policies out of Washington D.C.

Despite this backdrop, hope springs eternal on Wall Street where new highs were reached during the quarter and stock prices remain buoyant.

In an environment where economic growth is tepid, financial market prices are high, and the Fed is raising interest rates, financial history proves that it makes sense to be somewhat more cautious than normal. It is also a time when an increasing number of investors are investing for themselves, finding

Billions For Bargain Shopping Bershire Hathaway's Cash On Hand



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Cheviot is a completely independent financial advisory firm. We put our clients first in everything we do.

the bull market to be a place for easy profits. It is never easy. (As the brilliant Charlie Munger once said crisply, “Anyone who finds it [investing] easy is *stupid*.”) Another reason to be vigilant is because bargains are scarce. This is a natural byproduct of high prices. In turn, we are happy to hold more money market funds and bonds than normal as we scour the markets and wait for intelligent investment opportunities. But don’t take our word for it. Read what Charlie’s partner, Warren Buffett, does during times like these in *Is Warren Buffett Hoarding Cash?*, below.

IS WARREN BUFFETT HOARDING CASH?

No. At least, not intentionally.

The coffers of Berkshire Hathaway are overflowing with cash, now roughly \$100 billion worth. (When we say “cash” we are referring to cash and bonds, which Buffett views as readily available or “liquid” in the event he and his investment lieutenants find intelligently-priced stocks and companies to purchase.) This piling up of cash is due to Berkshire’s various subsidiaries generating copious free cash flow and Buffett and his partners finding not enough to buy with it.

Buffett’s hugely successful long-term record is due to various factors, but chief among them is his requirement that Berkshire own high quality companies and that he not pay too much to acquire them. “A business with terrific economics can be a bad investment if it is bought at too high a price,” he wrote in this year’s annual shareholder letter. Yet high prices exist today. Because the price one pays for an investment is a significant determinant of that investment’s future return (and the higher the price, the lower the return), Buffett avoids high-priced goods.

Analogizing this to baseball, Buffett said in November, 1974: “The stock market is a no-called-strike game. You don’t have to swing at everything — you can wait for your pitch. The problem when you’re a money manager is that your fans keep yelling, ‘Swing, you bum!’”

Buffett has no clients making requests. He buys only when it makes sense to do so. He continues, “All day you wait for the pitch you like, then when

the fielders are asleep, you step up and hit it.”

Today’s fielders are not asleep. They are invested aggressively and probably holding much less cash than normal. This is what happens in a bull market for stocks.

“It’s just astounding to me how willing people are in a bull market to toss money around. They think it’s easy,” said Buffett during the 2001 Berkshire annual meeting. And let’s not forget what Buffett’s partner, Charlie Munger, said on the top of Page 2 about those who think it’s easy.

Markets are cyclical. They sway from periods of greed to those of fear and back again. When it becomes difficult for others it can be a great time for those who hold cash. “The key to success is emotional stability,” says Buffett. Not being fully invested and tied to the full extent of every market gyrations makes it easier to maintain emotional stability. “The main thing an investor needs is the proper temperament. He doesn’t have to have a 150 I.Q. He doesn’t have to be an expert on accounting. But he does have to keep his balance when untoward things happen in the market. The reason investors do poorly is they beat themselves.”

We believe that it is easier for an investor to remain calm when they have a good amount of cash by their side, ready to be put to work when others need it and are willing to sell to us their underpriced stocks to get it.

“There are always going to be times when humans act irrationally and this is the time to make your money. I’ve made a career of cashing in when people are irrational,” said Buffett in 2007.

See the graph titled “*Billions for Bargain Shopping*.” This depicts how much cash Buffett’s company has held during the past nearly 30 years. The precipitous decline in cash in 2008 through 2009 occurred during the Great Financial Crisis. Others were selling during the crash. Not Warren. He bought tens of billions of dollars’ worth of investments.

“You’ve got to put your emotions aside. People get excited [and buy] at the wrong time and they get depressed [and sell] at the wrong time,” he recounted to CNBC viewers in May 2011.

“Cash combined with courage in a time of crisis is priceless,” he once said.

There is no crisis of late with the market hitting recent new highs. While Buffett remains very positive on the long-term future of the U.S. economy and financial markets, he will not buy stocks if no great opportunities exist.

“We don’t get paid for activity; we get paid for being right. As to how long we’ll wait? We’ll wait indefinitely.”

CHEERLEADER NO MORE

While in their leadership role at the Federal Reserve, Fed Chairmen are usually very optimistic when describing the condition of the U.S. economy. This may be due to a desire – or pressure – to remain upbeat about economic activity. Then, after stepping down from their post, former Chairmen have an uncanny ability to become more candid and pragmatic in their outlook for domestic economic conditions.

Former Chairman Alan Greenspan touted the late 1990s boom as supported by what he saw as a new plateau in corporate productivity. A few years later, he saw no risks in the housing boom of the mid-2000s. Subprime loans would not become a problem, he used to say, because the market was too intelligent to over-invest in them. The market knew best and a bubble they could not become. One year removed from his post, in 2007 he would comment that the subprime market was “an accident waiting to happen.”

Greenspan during the last several years has said numerous times that the U.S. economy faces new risks never before experienced. Keeping interest rates as low as they are for as long as they have been kept down will give way to unpredictable consequences. Greenspan should know given that under his watch it was the low “crisis-level” of interest rates from 2001 through 2004 that spurred the housing bubble and its difficult aftermath.

As for a global view, Greenspan recently stated that, “The Eurozone is not working.” While Chair of the Fed, he may have been less pointed, possibly choosing the words, “The Eurozone currently appears *somewhat challenged by temporarily suboptimal growth.*”

We applaud the candor of former Fed Chairmen if,

for nothing else, it provides a more realistic economic outlook. In recent months, former Fed Chairman Ben Bernanke was refreshingly frank, especially given his history as one to wear rose-colored glasses.

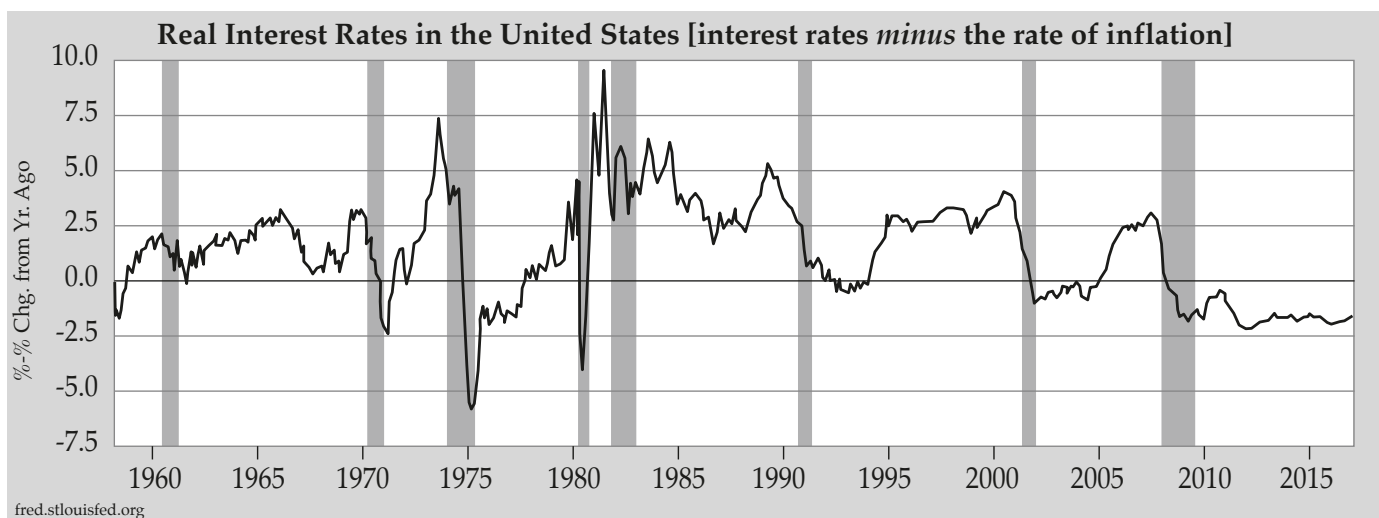
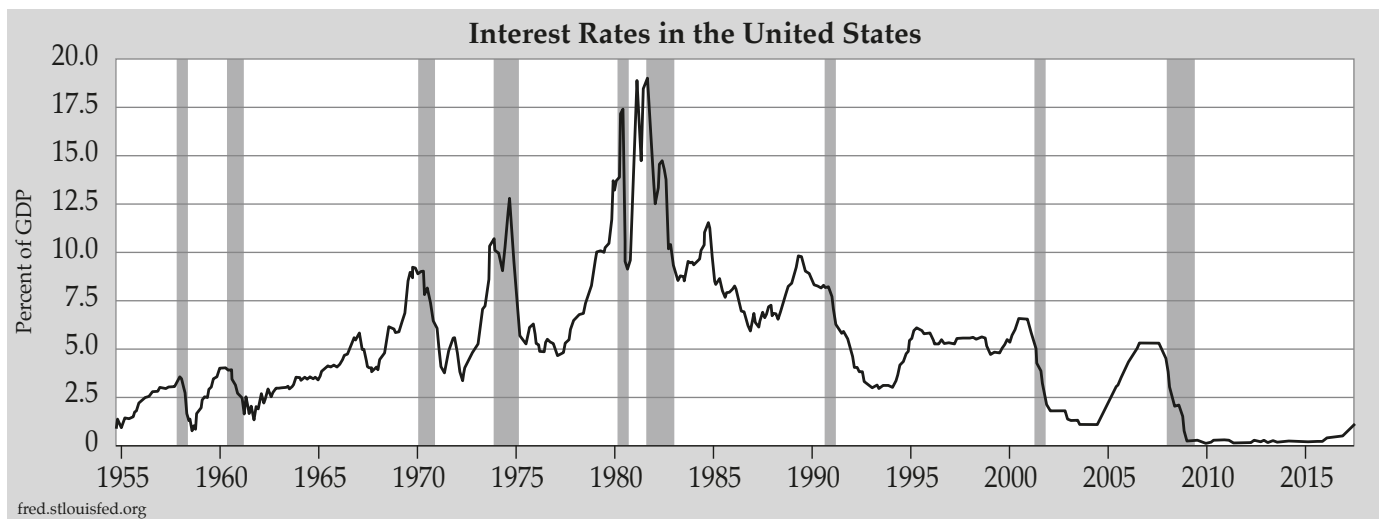
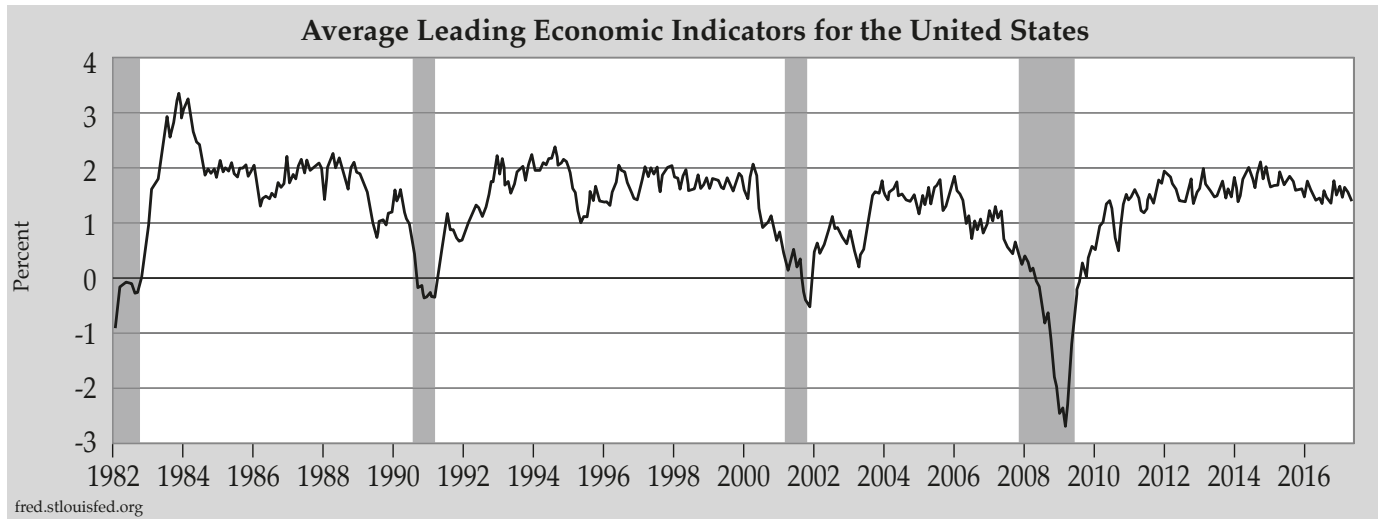
While in office as the leader of the Fed, then-Chairman Bernanke regularly spoke highly of the prospects for the U.S. economy. Furthermore, he consistently downplayed any meaningful risks. And meaningful they were. When we used these pages to describe the mid-2000s housing bubble and the destruction it would bring, Bernanke described a strong economy and no possibility that the entire U.S. real estate market could ever decline in concert. The housing market was not homogenous – it was regional, with each area possessing its own unique factors – claimed Bernanke, the great student of the Great Depression. Forgotten during Bernanke’s dismissal of such fears was the fact that, during the Great Depression, there was a *substantial* nationwide real estate downturn. Even when the housing market’s fuse was lit in 2007 and the market’s demise was in sight, Bernanke stated “we do not expect

-Continued 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



-Continued from Page 3

significant spillovers from the subprime market to the rest of the economy or to the financial system.” His infamously hopeful declaration that “subprime is contained” makes *Pollyanna* look like a world-class pessimist.

Today’s Bernanke is more balanced and less cheerleader. His current view on the economy is relatively mixed. He believes there is at least a 50/50 chance that the slow economic recovery since the Great Financial Crisis of 2008-09, already in its ninth year, will continue to plod forward for another couple of years. “It’s the little engine that could,” he says, while balancing that against “a pretty good chance” that the economy could slow before too long.

As for a major boost in economic activity, the type of which many market participants have hoped for since November’s Presidential election, Bernanke is not so sanguine. For a U.S. economy that has averaged 2% growth for several years, many believed it might be on the cusp of 4% growth. Not exactly, says Bernanke, who says that even 3% growth “is certainly possible – but not that likely.” The last year in which U.S. economic growth exceeded 3% was 2005 (and that growth was aided by massive and unsustainable withdrawals of homeowner’s equity that fueled consumer spending).

“We’ve got basically a 2 percent economy here. We have already approached the limits of our capacity and unemployment is pretty much about as low as it can go, so we don’t have that extra capacity to create growth.” That’s not something a sitting Chairman would say.

Bernanke does not believe that major tax cuts will be enough to get GDP growth in the U.S. back to 3%. And the chances for achieving dramatic corporate tax reform are dim: “In tax policy,” says Bernanke, “corporate tax reform could be helpful if it stimulates capital investment, but as a practical matter it doesn’t look like major reform is very likely.”

A distracted White House, says Bernanke, will make it “harder now, obviously” to create effective fiscal policy. But U.S. infrastructure could use the help. “Look around,” he says. “Obviously, infrastructure in America is not where it should be and smart

investment there could make us more productive and that could help longer-term growth.” Like many of us, he would like to see, “Better bridges, roads, schools, all the things on the infrastructure side.”

Unfortunately, in his words, “I’m not counting on major changes in the tax code or infrastructure.”

As for financial markets, Bernanke again dropped the coolness that was so pervasive during his tenure as Fed Chair: “I think the markets over-did it [optimism stemming from hoped-for pro-growth economic policies from the new presidential administration] early on.” Bernanke expects financial markets to “recognize that policy changes are going to be slower, smaller, later than they originally thought... From a U.S. policy perspective, it’s not going to be as big or as effective as some of the markets originally anticipated.”

While seeing “plenty of risks in the world,” Bernanke is amazed at the market’s recent indifference. In particular, “It always puzzles me a little bit that markets are blasé about political risk until the last moment.”

Bernanke thinks it would be “reasonable and sensible” for President Trump to nominate current Fed Chairwoman Janet Yellen for a second term when her first expires at year-end 2018. No matter the timing of her eventual exit from the Fed, we look forward to when she can comment more candidly about the state of the U.S. economy.

SAY IT AIN’T SO, JANET!

There are many financial quotes that later become famous for being proved spectacularly wrong.

In 1929, the country’s top economist, Irving Fisher of Yale, stated, “Stocks have reached what looks like a permanently high plateau.” The Great Crash of 1929 occurred just nine days later.

In 1973, Alan Greenspan, future Fed Chairman, opined in *The New York Times*: “It is very rare that you can be as unqualifiedly bullish as you can be now.” Stocks reached their peak within four days and during the next two years suffered their largest decline since the aforementioned crash.

In 2006-07, Fed Chairman Ben Bernanke proclaimed the U.S. housing market healthy so many

times that we lost count (even though we were critical in these pages at the time). Remember his famous words “the subprime housing crisis is contained” and that there would be no spillover from a potential decline in housing to the rest of the economy? The Great Financial Crisis ensued.

Just before we went to print, Janet Yellen, the current Chairwoman of the Fed and a normally thoughtful speaker, took her turn tempting fate. Citing a U.S. banking industry currently in better condition than at any other time since the 2008 crisis, Yellen made the following bold prediction: “Would I say there will never, ever be another financial crisis? You know probably that would be going too far but I do think we’re much safer and I hope that it will not be in our lifetimes and I don’t believe it will be.”

Now, to her credit, Yellen did not specify exactly *whose* lifetime. But we know she was not speaking to a roomful of centenarians. And while we also see no crisis looming (at least in the near-term), we ask: over a *lifetime*? When she uttered those words recently, we just knew that economic and financial historians cringed. We certainly did.

Good times breed complacency. Good investors are ever-vigilant.

Warren Buffett says that a great investor must be able to see risks that others do not and to visualize risks that have not previously occurred. We would like to see a little more of this trait in our current Economist-in-Chief.

CREDITS

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

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CHEVIOT VALUE MANAGEMENT, LLC

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

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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.

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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.

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Liquidity:

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

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Affordability:

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

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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*.

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

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