

# INVESTMENT VALUES

Issue Number 88, October 2008

*"Cheap money is the most dangerous intoxicant known to economic life, especially if it be prolonged through many years." – Benjamin M. Anderson*

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## CURRENT OUTLOOK

"U.S." herein refers to the Government of the United States, unless otherwise apparent from the context. Policies of the U.S. originating in the 1930s commit the U.S. to financing home purchases, insuring bank deposits, and maintaining full employment and economic stability. These policies were adopted at the depths of the Great Depression of the 1930s in response to problems of the time. The unintended consequence of these policies is the present financial crisis. Our understanding of the causes of this crisis informs the strategies we have developed to protect our clients' accounts from losses while building the real value of their assets in the years ahead.

### *CVM performance during the current financial crisis*

The U.S. stock market, as represented by the S&P 500<sup>1</sup> [*end notes appear on page 10*] began to suffer from the current financial crisis in mid-July 2007. From its peak on July 19, 2007 to September 30, 2008 the S&P declined 22.78% including dividends.

In comparison our firm's Composite gained 0.51% before fees over the same time. The Composite has not yet been audited for the period from the peak of the S&P on July 13, 2007 to September 30, 2008, but we believe the returns cited above are accurate. Our Composite includes all fee-paying portfolios over \$250,000 under our discretionary management, constituting about 80% of assets under our management.

### *Our Strategy*

For the one, three, five, eight and 10-year periods ended September 30, 2008 our Model Portfolio and our clients' accounts have performed far better than the S&P 500. This is not an accident. In this newsletter we discuss the problems we saw in financial markets and the steps we have taken to protect our clients, for example:

- We did not join in the speculation of 1999-2000 and thus avoided the enormous losses in technology, telecom and popular but over-priced large company shares.
- In April 2004 we said that extremely low interest rates and lax lending standards were causing a real estate bubble that would end badly. We were sure that some of the largest banks would suffer crippling losses from their reckless lending practices.
- We saw risky speculation in the stock market. Anticipating difficulties in the stock market, four years ago we initiated a position in the Prudent Bear Fund (BEARX), and significantly increased our stake in the summer of 2007, just as the stock market was peaking. BEARX

is designed to rise when the stock market declines; of course, that means generally that it will decline when the stock market rises. From mid-July 2007 to September 30, 2008, BEARX is up 23.1% including dividends.

- We saw increasing danger of inflation and risk to the relative value of the U.S. dollar due to the policies of the Federal Reserve and our country's ever-growing national debt and trade deficit. Precious metals are a classic hedge against high rates of inflation and a weakening currency. For more than three years we have been accumulating a growing position in precious metals (gold and silver) with individual company shares, the Market Vectors Gold Miners ETF (GDX) – a fund of 35 gold and silver mining companies – and the Central Fund of Canada (CEF) which holds gold and silver bullion.

### ***Depressed markets present investment opportunities***

Legendary investor John M. Templeton proved throughout his outstanding 40-year career that the best time to invest is when the outlook is most gloomy and pessimistic. Writing last year at age 95, Templeton summarized his philosophy as follows:

*"[In] selecting publicly traded investments...you are trying to buy a share at the lowest price in relation to what a corporation is worth...To get a bargain price, you have to look where the public is most frightened and pessimistic...To buy when others are despondently selling and to sell when others are avidly buying requires the greatest of fortitude and pays the greatest ultimate reward."*<sup>2</sup>

Another legendary investor, Warren Buffett said earlier this year: "If a stock I own goes down 50%, I'd look forward to it. In fact, I would offer you a significant sum of money if you could give me the opportunity for all of my stocks to go down 50% over the next month."<sup>3</sup> Of course, Mr. Buffett meant by this remark that he would consider a 50% price decline in his favorite companies an opportunity to buy more of their shares at a bargain price.

The S&P declined 40.6% over the 12 months ended October 10, 2008, with half that loss occurring

in just the last of the 12 months. That is definitely a stock market crash. For the sake of our clients' peace of mind, we hope no further decline occurs any time soon. However, if it does, we are ready for the opportunity to buy high quality company shares at bargain basement prices.

Despite all our country's present problems, we agree with Warren Buffett that it is appropriate to be optimistic about the long term outlook for America given the remarkable history of growth, innovation, and wealth creation America has achieved over the past 200 years.

### ***Mutual Fund Meltdown***

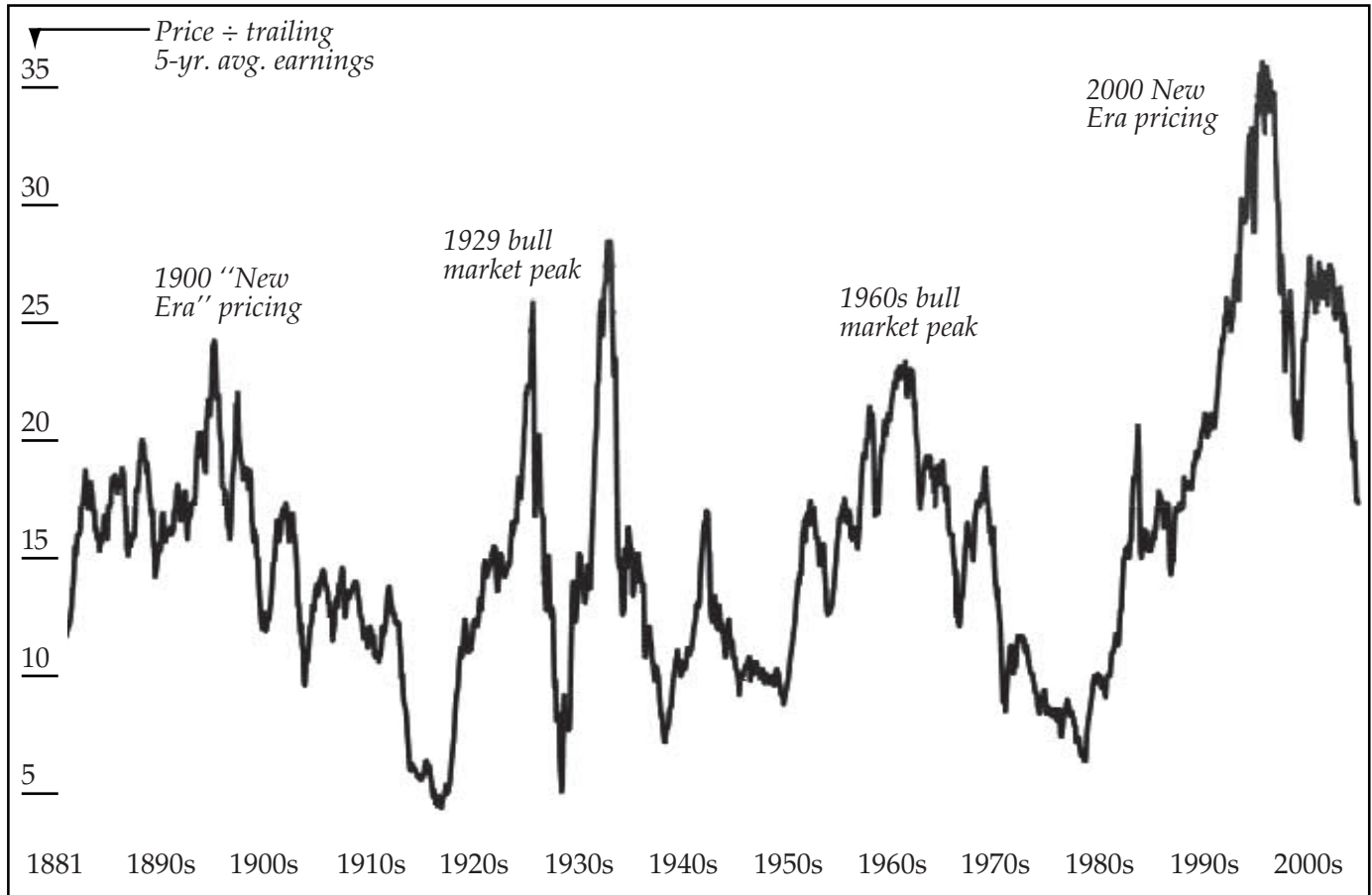
We are shocked to see the disastrous performance of well-regarded equity mutual funds over the past year. Twelve prestigious equity mutual funds that we surveyed were down over 35% on average for the 12 months ended 9/30/08. Not one was down less than 24% and the shrinkage in market value accelerated in early October.

In seeking an explanation we examined the portfolios of several of these funds to discover what went wrong. The funds were fully invested in stocks throughout the period; they held very little cash so they were exposed to the full force of the market decline. They had done nothing to hedge the risk of the market such as we have done with our positions in the Prudent Bear Fund and our precious metals holdings. These funds did worse than the S&P because they were taking aggressive positions in companies that did worse than the stock market averages, such as financial stocks, the worst performing group over the past year.

### ***International Over-Exposure***

It has become the conventional wisdom that international diversification in the stock market is essential to increase safety and also to increase returns. This idea has been almost universally accepted in academia and thoroughly disseminated in the financial media in recent years. The standard terminology is that equity investors ought to have international "exposure," a term repeated so often that it has begun to sound like a mantra.

## STOCK MARKET PRICE/EARNINGS RATIOS: 1881–2005



Source: Robert J. Shiller\*

\*Based on Standard & Poor's composite Price Index 1926-2008; and Cowles and associates, *Common Stock Indexes* for years prior to 1926

In recent years we did not see enough value in foreign stocks to justify a commitment to them. Therefore, our clients have not had international "exposure" and that's a good thing, because recently foreign stock markets have gone down even more than the U.S. market. Compared to a decline of 22% for the S&P 500, the Chinese stock market fell 59% in the 12 months ended September 30, 2008 while stock markets in Russia, Japan, Spain, Brazil, India, Italy, South Korea, Singapore, Sweden, Taiwan, and Hong Kong all fell 30% or more.

### *The U.S. Stock Market: a Long-Term Perspective*

The accompanying graph shows what happens when the stock market is over-priced in relation to established earning power of America's great

public companies. The graph shows the market price of the S&P 500 divided by the average earnings of the five prior years. For example, the price at the peak in early 2000 was 35x the average earnings reported for the years 1995-1999 inclusive.<sup>4</sup>

The peaks in 1900 and again in 2000 were accompanied by a widespread belief that a "new era" was at hand in which high share prices were justified by high future prospects. Just look at what happened after the "new era" thinking became prevalent: the aftermath of each peak was a severe decline. There was also new era talk in the run-up to the 1929 and mid-1960s bull market peaks.

Just a year ago pundits were saying in the financial media that stocks were reasonably priced because the PE ratio was 18x, only a little above the 17x average of the past 60 years. Looks can be

deceiving. The year ago market PE ratio did not appear unreasonably high because the “E” was inflated by temporary profitability that was the product of America’s unsustainable borrowing and spending spree.

Since this time last year the S&P is down 40% and its earnings are down 42% so the PE ratio is unchanged. The E is down so much because the American economy is contracting and some large financial companies’ profits have turned to gargantuan losses.

With economic activity contracting, many, if not most, companies may see their earnings shrinking, further lowering the E in the S&P. This indicates to us that share prices, generally, could come down more. We take no joy in the misfortunes of others. However, as value investors we are looking for bargains. As John Templeton says, bargains are usually most abundant when the outlook is most gloomy and pessimistic. We are prepared to buy bargains. Our clients’ accounts have ample cash, providing the wherewithal to go shopping in a depressed market.

### **MONEY, GOLD, BANKS, FINANCIAL LEVERAGE & CREDIT**

This article analyzes the characteristics of our system of money and banking which make our financial system inherently susceptible to repeated financial crises. At CVM our investment decisions take into account our understanding of the nature and function of money, gold, banks, financial leverage and credit.

#### ***Money and gold***

Ideally, money is a store of value, a medium of exchange, a unit of account, and has liquidity. Money is both a medium of exchange and the most liquid of assets, in that it can be used immediately to buy anything else in any amount without depressing its own value. Money is a unit of account in that it is the basis for measuring profit and loss and the growth or shrinkage of wealth.

Money is worth what it will buy. The U.S. dollar (USD) has been steadily losing buying power. In

1928 when the great basketball coach John Wooden graduated from high school, his father, a man of modest means, gave John a \$2 bill and said that if he kept it he would never be broke.<sup>5</sup> At the time there was such a thing as penny candy, a ticket to the movies cost 15 cents, a gallon of gas was 23 cents and a new Ford automobile could be had for under \$500.

In terms of the Consumer Price Index (“CPI”) the USD has lost 93% of its purchasing power since 1928. The USD has not been a good store of value. Gold *has* been a good store of value. In 1928 it cost \$20 to buy an ounce of gold. Currently an ounce of gold costs over \$800. Compared to gold the USD has lost over 97% of its value the past 80 years.

In a *Barron’s* interview some time ago, renowned gold expert Timothy Green said that in 1914 an ounce of gold would buy dinner for three and tickets to the theater at the Savoy Hotel in London, and that has remained true.

The USD and the British pound sterling were once considered “as good as gold” because the policy of each country was to manage their finances responsibly as evidenced by their undertaking to exchange sterling and the dollar for gold. That is no longer so.

In 1931 and 1933, respectively, Britain and the U.S. each repudiated the gold standard in order to be able to devalue their money.<sup>6</sup> The devaluation caused significant losses to other countries that had trusted the worth of British and American money. Some time later a Scandinavian central banker told an American economist: “*I have lost money in sterling. I have lost money in dollars. I have never lost money by holding gold.*”<sup>7</sup> Or, as Timothy Green says: “*The great strength of gold throughout history has not been that you make money by holding it, but rather you do not lose.*”<sup>8</sup>

Given the ongoing deterioration of the finances of the U.S. government and the growing risk of higher inflation we expect that over the next few years our precious metals commitments will do very well in relation to the U.S. dollar and the overall stock market.



## *Banks*

Banks are establishments for the deposit, safe-keeping, withdrawal and lending of money. One can store money in a safe deposit box at a bank. The money will always be there, you will pay a storage fee rather than being paid interest, but the money can not be spent without going to the bank to withdraw it from the safe deposit box.

Money in a typical bank account is not segregated and kept for immediate return. Rather, most of it is used by banks to make loans. Typically, banks lend out 10 to 20 times as much as they have readily available to meet obligations to depositors. A financial institution is considered a “non-bank” bank if it finances its lending by getting money from investors in exchange for bonds or similar IOUs.

A constant danger to banks arises from borrowing short term and lending long term. Bank deposits are shorter-term obligations of the bank to depositors, while loans are longer term obligations of borrowers to the bank. If word gets out that a bank has large loan losses many depositors become worried about the safety of their money, and ask for their money all at once, in what is called a “bank run.”

Since the start of the current financial crisis in the summer of 2007 there have been runs on three large banks here in California: Countrywide, IndyMac and Washington Mutual.

## *Financial Leverage*

Suppose you think that shares of a publicly traded company will double in short order. If you are right you can buy them and sell soon for a 100% profit. You can also engage in financial leverage through financing 50% of the purchase price with a margin loan from your broker. If the shares double in price, rather than doubling your money you have tripled it after paying off the margin loan. On the other hand, if you borrow and the shares go down by half, your broker will demand payment of the loan, and if you don't pay the broker will sell the shares, and you will lose 100% of your commitment. That is how financial leverage works.

Financial leverage is involved in the operation of every financial institution that takes in money from depositors or investors to put to work in loans or any other profit-seeking operation. A typical American bank operates with leverage of 90% to 95%, because most of its assets are customer deposits. Thus banks typically operate on a capital “cushion” of 5% to 10% of their obligations to depositors and other creditors.

If a bank that is 95% leveraged experiences loan losses approaching 5% of assets, that bank will soon be out of business. Depositors entitled to far more than 5% of assets will demand, and be entitled to, their money back, while those who borrowed from the bank don't have to pay until their loans come due.

**Government supervision of banks has three goals: requiring that banks have an adequate capital cushion, preventing bank runs if a bank gets into trouble, and taking over bankrupt banks to cover deposits before the panic spreads to other banks.** In the current financial crisis, escalating real estate loan losses have so impaired the capital of major American banks that our country has been undergoing the world's largest bank run, compelling the U.S. to undertake an unprecedented and extremely costly rescue operation to prevent a collapse of our financial system and the American economy.

## *Credit*

Credit is reliance on a promise of future payment. Credit is the life blood of society. In every day life we all use credit when we pay with a check drawn on a bank – a promise that our bank will pay from our account – or with a credit card – a promise that the credit card company will pay the vendor.

We might use cash at a restaurant or grocery store, but not to buy anything expensive. Commerce, industry, and finance operate almost entirely on credit. Businesses don't use cash for much, if anything.

Credit relies on confidence. If we are confident someone will pay his or her obligations, that person has good credit. People have poor credit because

their credit history shows they are unreliable in paying their obligations. Individuals, businesses, and even countries may have good or bad credit.

### ***THE FINANCIAL CRISIS OF 2008:***

#### ***Public Policy, Human Nature, Speculation & Risk***

America has had financial crises before, in 1907, the 1930s, and the 1980s, each fueled by creation of a flood of new money and new debt through extension of credit to borrowers, enabling them to speculate in assets that have been rising rapidly in price. When each speculative boom turns into a bust, asset prices fall below the level of debt incurred to acquire the assets during the boom. Then speculators and lenders alike suffer losses.<sup>9</sup>

#### ***Public policy***

It is the policy of the U.S. to promote and finance affordable housing. The U.S. has created five agencies to carry out this policy. The two largest and most important are the Federal National Mortgage Association (Fannie Mae or Fannie) and the Federal Home Loan Mortgage Corporation (Freddie Mac or Freddie).<sup>10</sup> Fannie and Freddie were privatized four decades ago. Shares in each were sold to the public and the shares eventually were listed on the New York Stock Exchange. Fannie and Freddie have financed about half of the dollar value of American home loans.

Last month the U.S. took over Fannie Mae and Freddie Mac because they were bankrupt. The U.S. had to seize them to prevent disruption of the market for home loans and to prevent the current financial crisis from becoming far worse. The problems at Fannie and Freddie illustrate and represent much of what has gone wrong in the American financial system in recent years.

Fannie and Freddie buy and guarantee home loans, rather than originating the loans. They had a competitive advantage in the mortgage business because of an implicit guarantee of their obligations by the U.S. Government. Therefore, they could borrow at lower cost than their competitors.

The Federal Reserve (the "Fed") is indirectly but importantly involved in the market for

residential real estate and home loans.<sup>11</sup> Through raising or lowering the Fed Funds Rate, the Fed and the Federal Reserve Banks raise or lower the costs of borrowing. By lowering or raising short-term interest rates the Fed can stimulate or restrict the economy by making it cheaper or more expensive to borrow.

A former Chairman of the Fed famously said that the job of the Fed is "to take away the punch bowl just as the party gets going."<sup>12</sup> He meant that the Fed ought to raise interest rates to rein in speculative and potentially dangerous economic activity.

Over a four-year period from March 1989 to May 1993 the Fed repeatedly cut the Fed funds rate, taking it down from 9.85% to 3.0%, to help the ailing banking industry recover from calamitous real estate lending losses.<sup>13</sup> These repeated cuts gave banks incentive to provide more cash than was needed for normal economic activity, and reduced the return on cash savings. Consequently much of the extra cash went into the stock market, fueling a continuation of the rise that took the S&P up over 1,200% from 1982 to 2000.<sup>14</sup>

Beginning in October 2001 the Fed began *spiking* the economic punch bowl, moving short-term rates below 3% for the next 3½ years, and pegging them at 1% for a full year, between June 2003 and June 2004. Consequently, mortgage interest rates fell to 40-year lows.

These low mortgage interest rates together with lax lending standards stimulated the real estate market, contributing mightily to the rise that was in process of doubling home prices from 1997 to 2005. In prior decades, a home buyer typically needed a down payment of 20% to get a real estate mortgage loan. By 2004 people were able to buy homes with little or no down payment.

Over this period there was also an increase in the use of Adjustable Rate Mortgages (ARMs) and sub-prime lending. ARMs offered a lower rate of interest to start than a conventional fixed rate loan. However, an ARM places the risk of higher rates on the borrower, as the ARM rate adjusts upward when interest rates rise.

Federal law actually *requires* banks to make home loans to people who would not qualify for

loans under prudent lending policies, because of lack of income or a poor credit history or both.<sup>15</sup> Loans to such borrowers are called “sub-prime.” From 1992 through this year the Congress pushed Fannie and Freddie to increase funding for sub-prime borrowers. Eventually, sub-prime lending became commonplace. In April 2005, at the peak of the real estate boom, Fed Chairman Greenspan said the increase in sub-prime lending was a good thing.<sup>16</sup>

Fannie announced in 2000 that by 2010 it would buy \$2 trillion in loans from low income, and risky borrowers. Freddie’s plans were similar. Subsequently Fannie and Freddie funded hundreds of billions of dollars worth of loans to sub-prime mortgage borrowers (many using ARMs) who bought houses with less than 10% down payment.

To satisfy continuing Congressional demand to finance “affordable” housing, even as house prices were peaking and then falling, Fannie and Freddie continued to fund sub-prime loans and so-called Alt-A or “liar” loans in which lenders made loans on the basis of a borrower’s stated income, without verification, even though it was easy for lenders to verify the borrowers’ income.<sup>17</sup>

In the early years of this decade Fannie & Freddie cooked their books by inflating earnings in order to justify stock option grants to executives, and to keep the share price high so the stock options were valuable.<sup>18</sup> The CEOs of the two firms made a combined \$128 million in the few years in which they were wrecking their companies.

Each company’s chief risk officer warned its CEO that the company was engaging in risky business. Fannie’s CEO responded that the market, shareholders *and Congress* all thought the companies should be taking more risks, not fewer. In mid-2004 Freddie’s chief risk officer told the company’s CEO that Freddie was purchasing bad loans that “would likely pose an enormous financial and reputational risk to the company and the country.” His CEO disregarded the warning.<sup>19</sup>

From 1992 through 2007 Congress was warned repeatedly by some of its own members and by Treasury Dept. officials that Fannie and Freddie presented a growing risk to the American financial system. Nothing was done because of (1) the

supposedly sacrosanct mission of Fannie and Freddie to promote affordable financing for home buyers; and (2) Fannie’s and Freddie’s aggressive lobbying and intimidation of Government officials and regulators. Congress permitted Fannie & Freddie to have 40 to 1 leverage (only 2.5% equity and 97.5% loans). However, a plausible estimate of their leverage is actually sixty to one; no one can tell for sure because the books of Fannie and Freddie are in disarray.<sup>20</sup>

The Congress has ultimate regulatory authority over Fannie and Freddie. They failed to exercise their regulatory power when most necessary. As late as 2007 the chairman of the House Financial Services Committee said “I’m not worried about Fannie and Freddie’s health, I’m worried that they won’t do enough to help out the economy. That’s why I’ve supported them all these years – so that they can help at a time like this.”<sup>21</sup>

### *Human Nature*

A dozen years ago, James Grant, a wise observer of the financial arena said: “Of all the consequences of sustained prosperity, none is so powerful as the delusion that markets always go up.”<sup>22</sup> There was such a delusion about home prices in recent years.

Our clients and readers will remember our warning of the dangers building in the real estate market in several articles in this newsletter as early as April 2004. The real estate market was so over-priced and poised for losses that in early 2005 our Darren Pollock wrote, and we mailed to clients, an 8-page letter warning them of the impending catastrophe in residential real estate.<sup>23</sup>

In recent years several trillions of dollars in residential real estate loans were made under conditions that virtually assured eventual huge losses to lenders, to our country, and much of the rest of the world. Those losses are now being realized and include the failure of lenders large and small including some of the largest banks, two of the five largest non-bank banks, the country’s largest insurance company, and The FDIC, the Government agency that insures bank deposits.

The boom and bust in real estate has evolved into what already appears to be a costly economic

recession. The financial crisis has caused large losses to other countries that invested in American debt obligations and has lowered our nation's prestige in the eyes of the rest of the world.<sup>24</sup>

Human nature has been a major factor in the financial crisis. In recent years all too many people were speculating or aiding and abetting speculation in homes, either knowingly or unwittingly, including home buyers, real estate agents, mortgage loan brokers, real estate appraisers and lenders.

Officers of lending institutions wrote many loans destined for default and foreclosure. They thought they could avoid loss on questionable loans by selling the loans to Fannie Mae and Freddie Mac or to Wall Street firms who would "securitize" them by packaging large numbers of loans for resale as bond-like mortgage-backed securities (MBS).

The three principal credit-rating agencies awarded triple-A ratings to these MBS. These ratings were based on a superficial and flawed system of risk analysis – one that assumed the rate of defaults and foreclosures in the aftermath of a speculative real estate boom would be no higher than in normal times.

### *Speculation & Risk*

Leaders of the large financial institutions who have failed recently knew that they were taking big risks, in two ways. They increased their financial leverage to an extreme level. Leverage averaged over 30 to 1 at the five largest Wall Street firms and was around 60 to 1 at Fannie and Freddie. To magnify profits further, these companies "invested" in a variety of types of risky loans, packaged as derivative securities that paid higher interest than safe bonds.<sup>25</sup>

A financial firm could buy insurance against loss in such derivative securities. The insurance was called a "credit default swap" (CDS). American International Group (AIG) was perhaps the largest seller of CDS contracts, insuring the value of \$500 billion of debt held world wide by banks, investment banks, pension funds, college endowment funds, foundations, insurance companies, hedge

funds, money managers, wealthy individuals, municipalities, etc.

Mounting mortgage defaults caused losses so large that AIG was facing bankruptcy. The U.S. considered that the failure of AIG to fulfill its CDS obligations would imperil the global financial system. To prevent that the U.S. decided to inject \$122.5 billion into AIG and take control of the company.<sup>26</sup>

As the use of derivatives was increasing enormously in recent years, a few people in and outside of the federal government became concerned that inappropriate use of derivatives could imperil the entire financial system. Warren Buffett commented that risk can not be eliminated. It can only be shifted around. He has also called derivatives "financial weapons of mass destruction."

Unfortunately, during the 1990s influential people such as a former Treasury Secretary and a former chairman of the Federal Reserve Board were influential in the opposition to efforts to rein in use of derivatives. The Fed chairman, Alan Greenspan, regularly commented that derivatives were "innovative financial contracts" that *reduced* rather than *increased* risk within our financial system.<sup>27</sup>

### *CASH*

Many investors do not fully appreciate the role of cash in an investment portfolio. Cash importantly provides (1) stability of value; (2) liquidity; and (3) serves as an opportunity fund for future investments.

**Stability:** While equity and fixed income market values can fluctuate (sometimes widely), cash does not. In a prolonged market downturn cash "outperforms" the market.

**Liquidity:** Cash is the most "liquid" of assets because it is immediately available for any need, such as living expenses, to serve as an emergency reserve fund, and to make new investments without having to sell existing holdings one may want to preserve. Selling an investment before its time can have harmful consequences. An investor foregoes possible future appreciation of an asset sold. Or, lack of cash may cause an investor to sell an asset



at a loss – perhaps just at the time when more of that holding should be purchased.

**Opportunity fund:** Cash is an opportunity fund for future investments. The vast majority of investment advisors customarily keep little or no cash on hand, instead putting almost all of their clients' assets into a variety of commitments. This strategy will prove deleterious to the overall portfolio in a falling stock market where an investor with cash in reserve can take advantage of bargain basement prices, while the one without cash has to sell something at a possible loss in order to buy something that is a bargain.

Holding significant amounts of cash is not an impediment to achieving a high rate of return on investments, as evidenced by Berkshire Hathaway. Over the 15 years ended September 30, 2008, Berkshire shares have outperformed the overall stock market by a wide margin, with returns averaging 14.71% per annum vs. 8.21% per annum for the S&P 500. Yet cash has been a prominent part of Berkshire's portfolio of marketable securities throughout this period. In Berkshire's 1993 annual report, Warren Buffett commented that: *"We'll try to resist the temptation to do something marginal simply because we are long on cash. There's no use running if you're on the wrong road."*

### ***The Safety of Cash in Your Portfolio***

A brokerage account holder's account is not subject to claims of the creditors of the brokerage firm, unless it is in a margin account. Unless otherwise required by a client all accounts managed by our firm are cash accounts, not margin accounts. Furthermore, Charles Schwab & Co., our clients' custodian, did not engage in any of the risky activities that brought down the large Wall Street brokerage firms.

Cash in a brokerage firm account is not protected by federal deposit insurance. It is invested in a money market mutual fund which is considered to be a cash equivalent. Currently, our clients' cash is in the Schwab Government Money Market Fund, which holds only obligations of the U.S. Government and its agencies. Being an

investment in obligations of the U.S. Government, it needs no insurance *by* the Government.

Securities Investor Protection Corporation ("SIPC") insures all securities, including cash held in money market funds, for up to \$500,000 per account. SIPC coverage insures against missing securities and cash at the custodian, but not losses due to investment decisions. Notably, there has never been an excess SIPC coverage claim during the more than three decades since SIPC was established.

In addition to SIPC insurance, Charles Schwab & Co. has its own misappropriation insurance coverage in the event that client assets are lost or stolen. Because a great number of brokerage accounts exceed a value of \$500,000, Schwab maintains "excess SIPC coverage" for up to \$150 million per account.

### **CREDITS**

Frederic G. Marks, Darren C. Pollock and David A. Horvitz contributed to the research, writing, and editing of this issue of Investment Values. Typographic design, formatting and printing are by Aldus Digital Graphics, Inc. of Los Angeles.

### **MODEL PORTFOLIO UPDATE**

The Model Portfolio was inaugurated on December 31, 1986 with hypothetical starting capital of exactly \$200,000.00. There have been no capital additions to the Model Portfolio. The only withdrawals have been hypothetical management fees. While there have been no additions, the portfolio's total cost basis has risen since 12/31/86 by adding to initial cost the amount of interest, dividends, and realized gains in the portfolio.

The table on page 12 shows the performance of the Model Portfolio, the Model Portfolio's common stocks, and the S&P 500 Index. The objectives of the Portfolio are, in order of priority, capital appreciation from marketable equity and equity-related securities, which at 9/30/08 comprised 81.6% of the Model (compared to 79.7% three months ago); and stability from inclusion of cash equivalents and fixed income

and related securities, which at 9/30/08 comprised 18.4% of the Portfolio (compared to 20.3% three months ago).

*Additions:* We added to existing holdings in Walgreen Co., 215 shares; Market Vectors Gold Miners ETF, 1,575 shares; and Pan American Silver, 1,250 shares. We initiated positions in Market Corp., 60 shares; Central Fund of Canada, 3,750 shares; and 25 William Wrigley Jr. Company bonds due July 15, 2010.

*Reductions:* We reduced the Model Portfolio's holding of Berkshire Hathaway by selling 15 Class B shares. We have been reluctant to make this adjustment because of the extremely high quality of Berkshire and its position as the only company continuously in the Model Portfolio since inception on December 31, 1986. However, the reduction was appropriate because the percentage of the Model Portfolio in Berkshire was much larger than the percentage of Berkshire in the assets under our management in clients' accounts. In no way is this reduction an expression of opinion by CVM regarding the current price or quality of Berkshire Hathaway.

*Eliminations:* BB&T Corp., 400 shares; Arthur J. Gallagher, 400 shares; and Sysco Corp., 670 shares.

## NOTES

<sup>1</sup>Standard & Poor's 500 Composite Price Index, referred to herein as the S&P 500 or the S&P, represents about 77% of the total value of American stocks. The S&P 500 covers a large and varied universe of companies, and is the most widely used benchmark of stock market performance.

<sup>2</sup>*Investing The Templeton Way* (2008), p. x, by Lauren C. Templeton and Scott Phillips.

<sup>3</sup>Quoted in "Stop Worrying, and Learn to Love the Bear," by Jason Zweig, *The Wall Street Journal*, July 12, 2008.

<sup>4</sup>We believe that the PE ratio would have been higher than 35x in early 2000 if the reported earnings were universally honest. Unfortunately, many companies had inflated their reported earnings by means of a variety of financial shenanigans.

<sup>5</sup>Wooden, John R., *My Personal Best: Life Lessons from an All-American Journey* (2004).

<sup>6</sup>Between 1880 and 1914 many developed countries fixed the exchange value of their paper money in terms of a specified amount of gold. This inhibited the power of a government to enrich itself at the expense of its citizens by monetary inflation. The gold standard broke down in World War I and was finally abandoned by all countries in the early 1930s.

<sup>7</sup>Anderson, Benjamin M., *Economics and the Public Welfare: A*

*Financial and Economic History of the United States, 1914-1946* (2nd ed. 1979), p. 254.

<sup>8</sup><http://www.rediff.com/money/2008/may/07gold1.htm>

<sup>9</sup>Kindleberger, Charles P., *Manias, Panics, and Crashes: A History of Financial Crisis* (5th ed. 2005), Chapters 4-6.

<sup>10</sup>The others are the Federal Home Loan Bank system, the Federal Housing Administration (FHA) and the Government National Mortgage Association (GNMA or Ginnie Mae).

<sup>11</sup>References to "the Fed" usually mean The Federal Open Market Committee (FOMC) which sets short-term interest rates. The FOMC consists of the seven members of the Board of Governors of the Federal Reserve System, the president of the Federal Reserve Bank of New York, and four of the remaining eleven Reserve Bank presidents.

<sup>12</sup>William McChesney Martin, Jr., Fed Chairman 1951-1970.

<sup>13</sup>The low fed funds rate enabled banks to borrow from the Fed and loan to depositors at higher rates, thereby restoring the banks' depleted capital.

<sup>14</sup>See Grant, James, *The Trouble With Prosperity* (1996), Chapter 4 entitled "Miracle Cure."

<sup>15</sup>The Community Reinvestment Act of 1977 (as strengthened in 1995).

<sup>16</sup>Quoted in Fleckenstein, William, *Greenspan's Bubbles: The Age of Ignorance at the Federal Reserve* (2008), p. 159.

<sup>17</sup>Federal law permits a mortgage lender to require a loan applicant to execute a document authorizing the lender to get the borrower's income tax returns from the government.

<sup>18</sup>See "Peter Eavis Digs Into Fannie Mae," *TheStreet.Com*, 1-30-04; [http://www.thestreet.com/\\_tscs/comment/detox/10229969.html](http://www.thestreet.com/_tscs/comment/detox/10229969.html); and "Freddie Mac Finance Chief Resigns with Accounting 'Blueprint' in Place," by A. Shin, *Washington Post*, 3-23-06.

<sup>19</sup>"At Freddie Mac, Chief Discarded Warning Signs," by Charles Duhigg, *NY Times*, 8-5-08.

<sup>20</sup>Robert J. Samuelson, "The Confidence Game," *Washington Post*, 9-22-08.

<sup>21</sup>See "Pressured to Take More Risk, Fannie Reached Tipping Point," by Charles Duhigg, *NY Times*, 10-5-08; and "How Washington Failed to Rein In Fannie, Freddie: As Profits Grew, Firms Used Their Power to Mask Peril," by B. Appelbaum, C. Leonnig and D. Hilzenrath, *Washington Post*, 9-14-08.

<sup>22</sup>From *The Trouble With Prosperity* (1996), by James Grant, p. xiii.

<sup>23</sup>See <http://www.cheviotvalue.com/cvminthemedial.html> and select PrudentBear.com, May 2005.

<sup>24</sup>The boom and bust in real estate is not just an American event; it is global. Other countries are suffering from the collapse of their own real estate and credit bubbles.

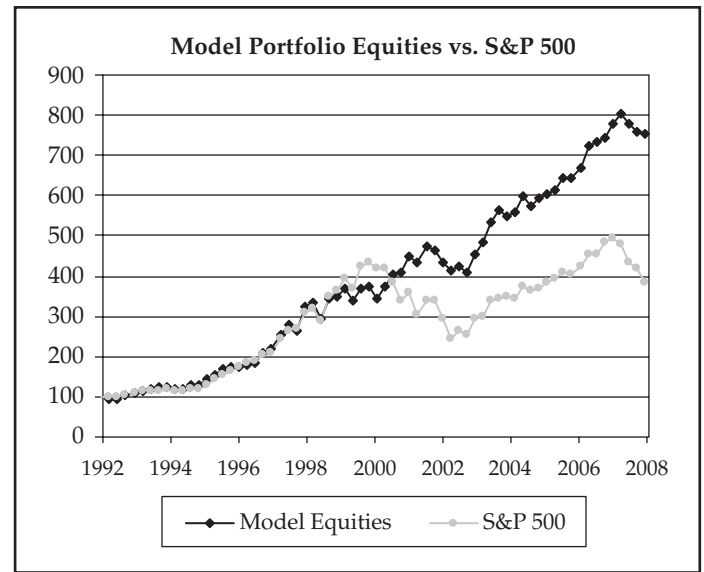
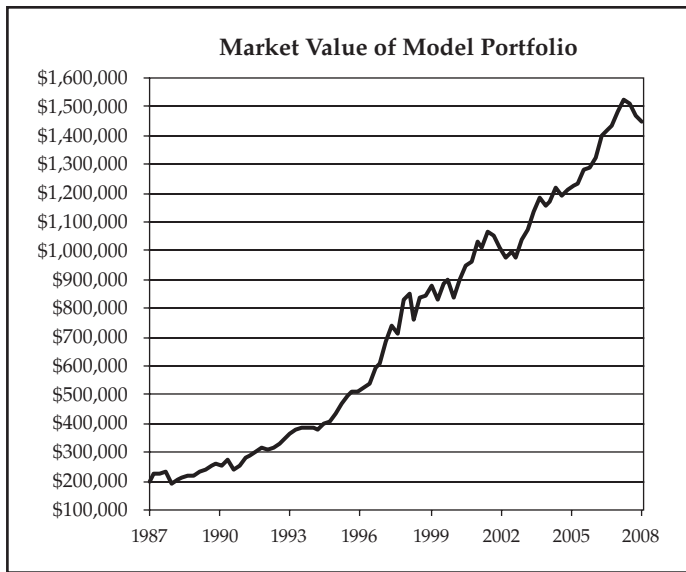
<sup>25</sup>These "derivative" securities bore arcane names such as mortgage-backed security (MBS), collateralized debt obligation (CDO), collateralized loan obligation (CLO), structured investment vehicle (SIV), etc.

<sup>26</sup>See "Behind Biggest Insurer's Crisis: A Blind Eye to a Web of Risk," by G. Morgenson, *NY Times*, 9-28-08.

<sup>27</sup>See "Taking Hard New Look at a Greenspan Legacy," by Peter S. Goodman, *New York Times*, 10-8-08. For a compendium of the mistaken utterances and policies of Mr. Greenspan, see *Greenspan's Bubbles: The Age of Ignorance at the Federal Reserve* (2008) by William A. Fleckenstein.

**MODEL PORTFOLIO: September 30, 2008**

Quantity	Security	Unit Cost	Total Cost	Price	Market Value	Pct. Assets	Yield
<b>EQUITIES</b>							
120	3M Company	74.16	8,898.97	68.31	8,197.20	0.6	2.9
150	Abbott Laboratories	40.73	6,110.00	57.58	8,637.00	0.6	2.5
475	Amgen Inc	62.13	29,512.39	59.27	28,153.25	1.9	0.0
1	Berkshire Hathaway-A	2,848.20	2,848.20	130,600.00	130,600.00	9.0	0.0
20	Berkshire Hathaway-B	94.94	1,898.80	4,395.00	87,900.00	6.1	0.0
1,100	Bristol Myers Squibb	25.65	28,217.93	20.85	22,935.00	1.6	5.9
200	Buckeye Partners LP	43.08	8,616.00	37.09	7,418.00	0.5	9.3
3,750	Central Fund of Canada	9.41	35,300.58	10.83	40,612.50	2.8	0.1
300	Chevron Corp	36.31	10,893.00	82.48	24,744.00	1.7	3.2
500	Donnelley & Sons	24.62	12,310.00	24.53	12,265.00	0.8	4.2
150	Exchange Bk Santa Rosa	73.28	10,992.50	67.25	10,087.50	0.7	0.0
630	Johnson & Johnson	61.22	38,570.39	69.28	43,646.40	3.0	2.7
60	Markel Corporation	364.88	21,892.77	351.50	21,090.00	1.5	0.0
2,575	Market Vectors Gold Miners ETF	37.39	96,282.98	33.79	87,009.25	6.0	2.2
550	Medtronic Inc.	50.62	27,838.40	50.10	27,555.00	1.9	1.5
1,975	Newmont Mining Corp	42.92	84,768.92	38.76	76,551.00	5.3	1.0
3,250	Pan American Silver Corp	18.28	59,402.55	22.23	72,247.50	5.0	0.0
500	Pennsylvania RI Est Tr	17.06	8,527.51	18.85	9,425.00	0.6	12.1
2,785	Pfizer Inc	25.60	71,307.61	18.44	51,355.40	3.5	6.9
300	Plum Creek Timber REIT	30.89	9,267.00	49.86	14,958.00	1.0	3.4
125	Stryker Corp	62.07	7,758.61	62.30	7,787.50	0.5	0.5
900	UnitedHealth Group, Inc.	41.51	37,355.78	25.39	22,851.00	1.6	0.1
900	Wal Mart Stores Inc	44.03	39,625.20	59.89	53,901.00	3.7	1.6
700	Walgreen Co.	36.44	25,508.28	30.96	21,672.00	1.5	1.5
1,611	Washington Federal	10.36	16,680.00	18.45	29,713.91	2.0	4.6
700	Washington REIT	14.05	9,832.77	36.63	25,641.00	1.8	4.7
450	Weingarten Realty Investors	18.06	8,126.00	35.67	16,051.50	1.1	5.9
435	Zimmer Holdings Inc	67.79	29,490.76	64.56	28,083.60	1.9	0.0
			<u>747,833.90</u>		<u>991,088.51</u>	<u>68.3</u>	
<b>MUTUAL FUNDS</b>							
28,230.075	Prudent Bear Fund	5.79	163,401.00	6.82	192,529.11	13.3	2.8
6,409.579	Prudent Global Income Fund	12.47	<u>79,910.00</u>	12.42	<u>79,606.97</u>	<u>5.5</u>	6.6
			243,311.00		272,136.08	18.8	
<b>FIXED INCOME</b>							
10,000	Kaiser Permanente 3.450% Due 05-01-11	99.68	9,968.10	99.62	9,961.60	0.7	3.6
25,000	William Wrigley Jr. Co. 4.300% Due 07-15-10	99.74	24,933.85	99.52	24,881.22	1.7	4.6
	Accrued Interest				<u>370.69</u>	<u>0.0</u>	
			<u>34,901.95</u>		<u>35,213.51</u>	<u>2.4</u>	
<b>CASH &amp; EQUIVALENTS</b>							
	Cash		152,191.59		152,191.59	10.5	1.7
<b>TOTAL PORTFOLIO</b>					<u>1,450,629.70</u>	<u>100.0</u>	



*Total return for one year; returns for periods greater than one year are annualized; all returns include dividends and interest; all Model returns are net of commissions and fees. Periods ended 9/30/08.*

	<u>1-year</u>	<u>3-year</u>	<u>5-year</u>	<u>8-year</u>	<u>10-year</u>	Since Inception: <u>12/31/86</u>
Model Portfolio	-1.95%	5.82%	6.21%	6.18%	6.71%	9.53%
Model Portfolio Equities	-5.15%	6.89%	8.85%	8.82%	9.71%	
S&P 500 Index	-22.03%	0.19%	5.16%	-0.88%	3.05%	

When investing clients' funds, securities listed in the Model Portfolio are the primary choice, provided, in our opinion, a Model Portfolio security then represents good value. However, inclusion of a security in the Model Portfolio is not necessarily intended as a purchase recommendation at the current price because a security may be retained in the portfolio as a long-term investment even after its price has advanced well above a bargain purchase level.

Past performance is no guarantee of future results. Any investment in marketable securities has the possibility of both gain and loss. Model Portfolio results do not represent actual trading and may not reflect the impact that material economic and market factors might have had on our decision making in accounts where clients' funds are actually under management. Clients' results can differ materially from the results of the Model Portfolio based upon a difference in a client's investment objectives, differing asset allocation, and a need to buy and sell securities on account of a client's withdrawals from or additions to the account.

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