

INVESTMENT VALUES

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"If you spend 15 minutes a year worrying about the market, you've wasted 14 minutes." - Peter Lynch

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OUR INVESTMENT OUTLOOK

Financial market volatility, which slumbered peacefully through most of 2016 and all of 2017, awoke suddenly in the first quarter of 2018. After quickly rising more than 7% in the year's first four weeks, U.S. stock prices abruptly retreated, ending the quarter lower by 1%. Market volatility was first stoked by fears of stronger inflation then the implementation of tariffs on imported goods, something the markets fear may lead to a trade war.

With decades of experience from which to draw, trade wars are almost universally viewed as depressants to global economic activity. Moreover, a trade war today risks upending the long-standing economic codependency between China and the U.S.: the Chinese sell far more goods to the U.S. than the U.S. sells to China, and China simultaneously buys large quantities of U.S. government bonds which helps fund U.S. deficits and keep U.S. interest rates low (thus boosting U.S. economic activity).

China is the third largest and most rapidly growing export market for the U.S. It is also the largest foreign holder of U.S. government bonds

at a time when the U.S. Federal deficit is rapidly increasing. The growing deficit forces the U.S. government to issue more bonds to bridge the gap between Federal revenues and expenditures.

Given the crucial relationship between the U.S. and China and the historical consequences of raising tariffs, it is no wonder that investors behave nervously when it appears that a trade war may be in the offing. Similarly, market participants breathe a sigh of relief and push stock prices higher when it appears that tough talk on trade is a negotiating tactic.

Increased market volatility and any economic slowdown from increased fears about tariffs and trade wars could lead to political turnover in the 2018 mid-term elections. This could be viewed unfavorably by the financial markets. At the same time, the Federal Reserve is slowly raising interest rates and selling bonds (both dampen economic activity). Numerous market metrics indicate relative overvaluation while underlying GDP growth remains just marginally above the 2% growth trajectory experienced during the past several years.

We are cautious in this environment, preferring to remain balanced in our portfolios of what we deem to be high quality investments. We continue to monitor not just the companies we own, but many others that we would like to own as we wait for them to reach sensible valuations before our purchase. With rising market volatility, we have welcomed an increase in the number of strong companies that are approaching attractive price levels.

Cheviot is in its 34th 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.

TESLA'S ALTERNATING SENTIMENT

Elon Musk is the brilliant visionary who founded several companies, including Tesla and SpaceX after co-founding a company that later became PayPal. Musk has been called “the next Steve Jobs.” He is such an “outside the box” thinker that he sold 20,000 flamethrowers for \$500 apiece to help fund another of his recent ventures, The Boring Company, which plans to bore traffic-easing commuter tunnels under Los Angeles.

One of inventor Nikola Tesla's pioneering designs lead to a power generator's use of alternating current. For the auto company, Tesla's breakthrough was building an attractive, high-end electric vehicle (“EV”). This spurred innovation throughout the auto industry as competing car manufacturers responded by pouring billions of dollars into catching up and developing their own EVs.

One major difference in what Musk and, say, Henry Ford faced as automobile innovators, however, is that Musk has no shortage of well-heeled, established competitors eager to defend their turf. Volkswagen alone will spend \$40 billion on EVs and battery production in the next few years. GM's Chevy Volt outsold all Tesla models in October of 2017 and nearly matched Tesla's total sales in November.

While its competitors earn billions per year in profits, Tesla's losses force it to issue more bonds and shares to finance its operations. It is dangerous for a company continually to rely upon the generosity of the capital markets to lend it money. The capital markets believed Musk's production projections for years but may lose hope that the company will become a self-sustaining, profitable enterprise. Tesla's ability to raise money may prove more difficult as, per noted financial sleuth Jim Chanos, “capital markets tend to close from time to time.”

Tesla's autonomous vehicle technology ranks last in the industry of 18 other car and tech companies. The car's Autopilot function was in control of a car that crashed on March 23rd, killing its driver. “You have a company that is supposedly a technological leader that is *behind* in the most exciting part of the technology – autonomy. We're puzzled. But don't

ask us, ask the scores of top executives that left the company in the past two years. What do they see?” questions Chanos.

A year ago, the company's CFO departed after less than two years on the job. Earlier this year, two more prominent execs, the company's Chief Accounting Officer (“CAO”) and its Treasurer/VP of Finance, jumped ship after brief stints with the company. Experienced investors understand that corporate executives may leave for various reasons but the departure of so many finance insiders is a red flag. And in the waning days of the CAO and Treasurer, Musk convinced Tesla's compensation committee, and later received shareholder approval, to award himself a massive \$2.6 billion compensation package if certain financial targets are met.

The company's hopes for profitability have been pinned on the sale of the mid-priced Model 3 sedan. Unfortunately, production has been besieged by numerous quality control problems. Far fewer of these cars are being produced than expected and production goal posts continue to be pushed back.

For several years, Tesla's shares have defied both gravity and logic. If an investor applies to Tesla the valuation metrics of profitable auto companies and then very generously “rounds up” for intellectual property, brand value, and the company's first-mover advantage, he/she derives a share price for Tesla that is less than half of where the shares traded at quarter end, \$266. Arguments can be made that the shares are worth far less. Last fall, Tesla stock changed hands as high as \$389 per share.

In short, Musk deserves (and receives) tremendous credit for spurring innovation and pushing forward car technology. But Tesla is a loss-making enterprise with never-ending production problems, reliant on external funds to stay afloat, and operating in an industry of strong, profitable competitors with massive war chests. There are far too many unknowns – and potential red flags – to estimate reliably where Tesla shares will trade in the next few years. As our client, you understand well by now that the company's highly speculative shares do not represent the type of high quality business in which Cheviot prefers to invest. Keep the car, skip the shares.

CHARLIE MUNGER SHARES SOME WISDOM

Charlie Munger, Warren Buffett's business partner for nearly 50 years at Berkshire Hathaway, is considered by many (including Buffett and their mutual friend Bill Gates) to be the smartest person they have ever met. In short, his interests are wide, expertise vast and insights compelling. (For a fuller description of Charlie, see, *Darren Sits Down with Charlie Munger*, online at <http://cheviotvalue.com/publications/featured-articles/> or we will send you the letter upon request.) As Chairman of Daily Journal Corporation ("DJCO"), Charlie spent two hours during DJCO's annual meeting in February to answer questions on various subjects from the malpractices at Wells Fargo to Bitcoin to his views on an appropriate national oil policy.

The U.S. level of debt to GDP is extremely high. Charlie previously told our Darren Pollock that he expects the debt never to be paid off. At February's meeting, he said this about the high level of U.S. debt:

Of course, I'm concerned about the rising level of government debt. This is new territory for us, and new territories probably have some danger in it. On the other hand, it is possible that the world will function more or less pretty well, even with a very different pattern of government behavior than you and I would have considered responsible based on history to date. Look at the inflation we got out of the last hundred years when the announced objective of the government was to keep prices stable. Now the announced objective is 2% inflation. What's going to happen? The answer is, we don't know. But is the way to bet that inflation over the long-term is [going to be] way higher than 2%? I think the answer is yes.

Here's what we call "The Munger Policy on Oil."

Eventually it's going to get very hard to have more oil and eventually the price will go very high. As a chemical feed-stock it's totally essential, the hydrocarbons. So, it's never going to go out of vogue, and of course we're going to need it for energy for a long, long time ahead.

I think the correct policy for the U.S. would be not to produce our oil so fast. I think oil is so precious and so desirable over the long pull that I'd be

very happy to have more of our oil just stay in the ground and just pay up front to the Arabs to use up theirs. I think that would be the correct policy for the U.S. Only 99.9% of the rest of the people in world are against me! [Laughter] But why would we want to use up all our oil as fast as we can? Why would that be smart?

Berkshire Hathaway is Wells Fargo's largest shareholder. In recent years it was revealed that the company mistreated its customers in numerous ways. The U.S. Justice Department and FBI last month announced its investigation into improper behavior and various abuses at the company's wealth management division. Anticipating questions about Wells Fargo's unethical behavior, Charlie stated:

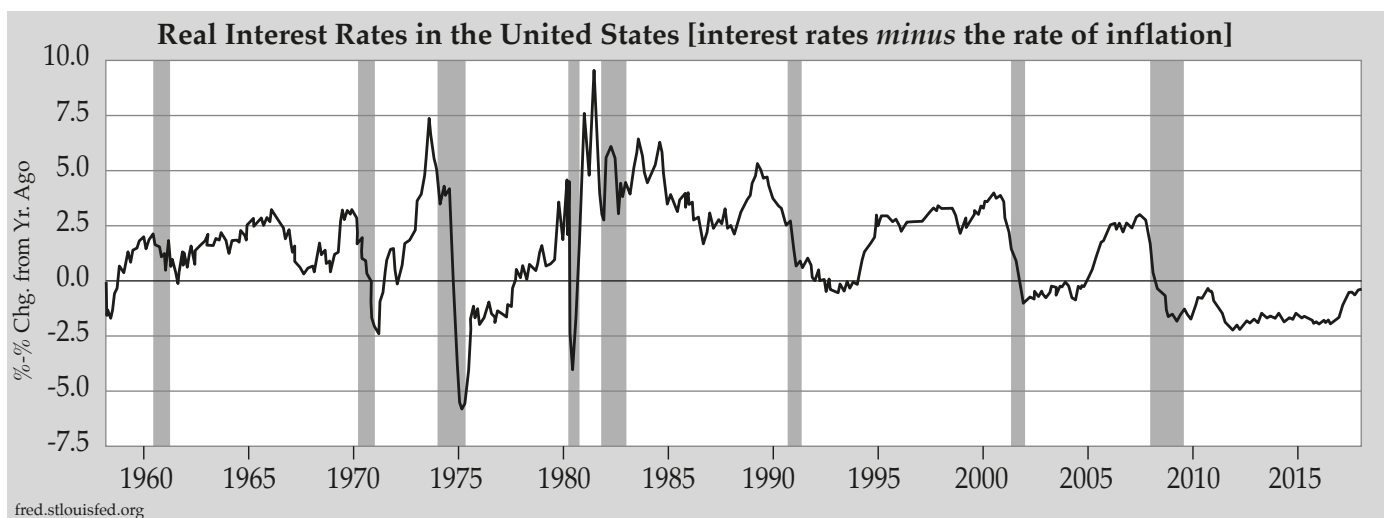
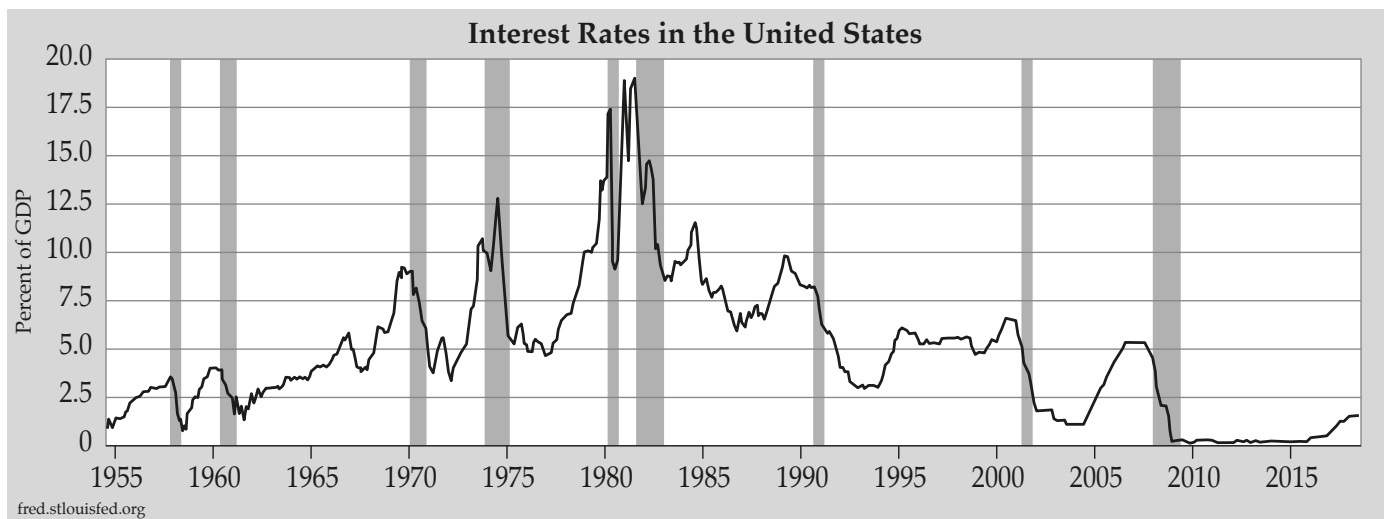
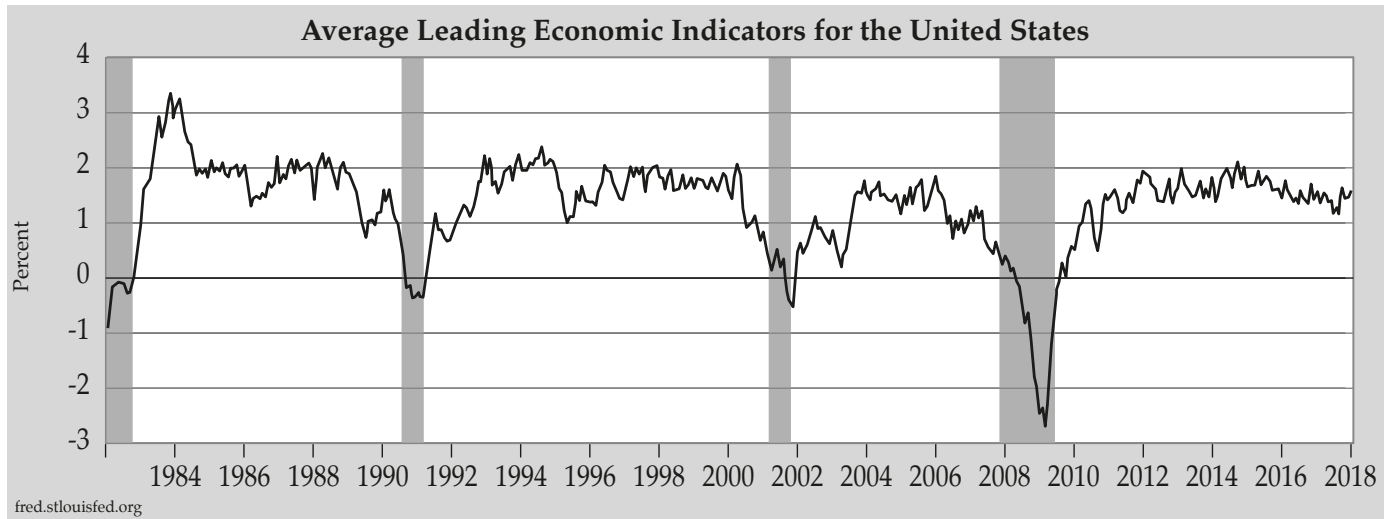
The Wells Fargo position is interesting, and I know I'll get questions about that, so I'll answer them in advance. Of course, Wells Fargo had incentive systems that were too strong in the wrong direction. And of course, they were too slow in reacting properly to bad news when it came. Practically

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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



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everybody makes those mistakes... If you asked people with long experience in management what their mistakes were looking backward, the standard response is, somebody who should have been removed wasn't and for way too long.

Any bank can make a lot of money by making a bunch of gamier loans at higher interest rates or abusing their customers with very aggressive treatments. And of course, banks really shouldn't do that.

The temptations that come to a banking CEO to do something stupid are way greater in banking than they are in most businesses. Therefore, it's a dangerous place to invest because there are a lot of ways in banking to make the near-term future look good by taking risks you really shouldn't take for the sake of the long-term future.

On Berkshire Hathaway's large purchases of airline industry shares and the need to change one's mind when the facts change:

For a long time, Warren and I painted over the railroads because there were too many of them, and it was too competitive, and union rules were too crazy. They were lousy investments for about 75 years. And then they double-decked all the trains and they got down to four big rail systems in all the U.S. in terms of freight and all of a sudden we liked railroads. It took about 75 years. Warren and I never looked at railroads for about 50 years, and then we bought one [Burlington Northern Santa Fe].

Now airlines, Warren used to joke about them. He'd say that the investing class would have done better if the Wright Brothers would never have invented flight. But given the conditions that were present when the stock was purchased and given the conditions of Berkshire Hathaway where it was drowning in money, we thought it was ok to buy a bunch of airline stocks. Certainly, it's ok to change your mind when the facts change... It is harder to create the little competing airlines. And the industry has maybe learned something.

Charlie was asked if he's ever owned shares in Hershey's or Tiffany's. His answer touches upon

something we call, "buying quality at an intelligent price."

Well, I'd be delighted to own either Hershey's or Tiffany's at the *right price*, wouldn't you? It's just a question of price. They're great companies. But that's not enough. You have to have great companies available at a price you're willing to pay.

Charlie minced no words regarding his distaste for Bitcoin and cryptocurrencies:

I regard the Bitcoin craze as totally asinine... I never considered for one second having anything to do with it. I detested it the moment it was raised, and the more popular it got, the more I hated it. On the other hand, I expect the world to do insane things from time to time. Everybody wants easy money. And the people who are peddling things and taking money off the top for promoting the investment, they like it too. And so these crazies just keep coming and coming and coming. But who would want their children buying things like Bitcoin? I just hope to God that doesn't happen to my family... I'm not saying that some different payment system might not be a good thing like WeChat [in China]. But Bitcoin is noxious poison... And the government of China, which is stepping on Bitcoin pretty hard, is right and our government's more lax approach to it is wrong. The right answer to stuff like that is to step on it hard, and it's the government's job.

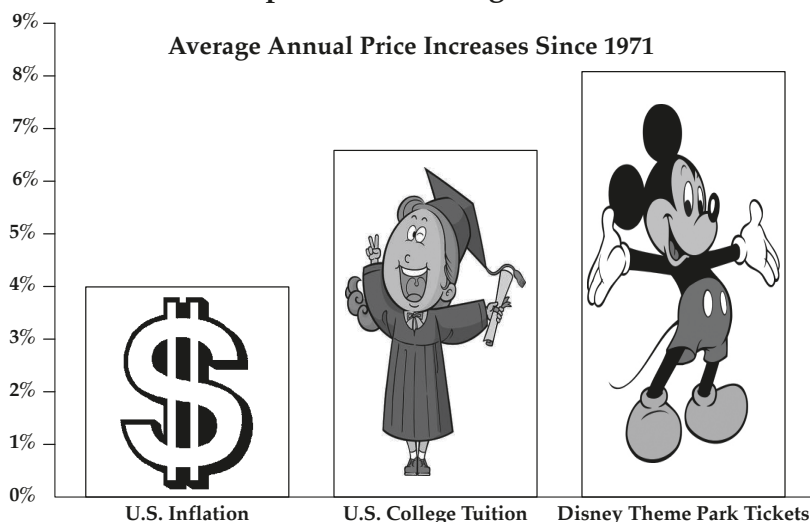
MODEL PORTFOLIO UPDATE

In the year's first quarter, we initiated a position in the shares of The Walt Disney Company ("DIS"). Disney operates a unique collection of media networks, film studios, and theme parks which help market another of the company's businesses: Disney-branded consumer products. Through three of Disney's movie studios—Pixar, Lucasfilm (Star Wars) and Marvel—the company routinely creates new characters which become long-lasting brands that are both parent-approved and children-desired. Similarly, Disney's dominant movie and tv studios create valuable content for its tv networks delivered traditionally via cable and satellite and increasingly via "over the top" streaming services (video programming delivered via the internet instead of cable or satellite).

"I find life works best when you are trying to stay rational all the time."

- Charlie Munger

Unparalleled Pricing Power



Warren Buffett states that pricing power is the surest sign of a strong company. Disney has raised ticket prices at its theme parks by 8.1% annually during the past several decades, more than twice the U.S. rate of inflation during the same time and even greater than the 6.6% average annual increase in the cost of U.S. college tuition.

Disney has agreed to acquire many assets of Twenty-First Century Fox, including its film and tv studios and numerous U.S. and international broadcasting stations. These assets will dramatically bolster an already-strong content offering – the combined companies are on pace to earn 40% of box office receipts in 2018 – as Disney builds a direct-to-consumer entertainment product to compete directly with Netflix. Reed Hastings, Netflix’s CEO, believes Disney’s future streaming service, “will be very successful because Disney has super-strong brands... It’s a great opportunity for them.”

Disney earns higher returns on equity and total capital, possesses greater earnings and dividend growth rates, and maintains a stronger financial condition than the average large company. The shares, however, trade at a valuation below that of the broader U.S. market providing us with what we believe to be a high-quality company at a discounted price.

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

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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