

# INVESTMENT VALUES

Issue Number 128, October 2018

*"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." - Warren Buffett*

CONTENTS	Page
<i>Our Investment Outlook .....</i>	1
<i>What Might the Mid-Terms Mean for the Market? ...</i>	2
<i>Year-End Financial Planning Considerations .....</i>	3
<i>Cheviot's Graphical Interlude .....</i>	4
<i>Credits and Disclosures .....</i>	7

## OUR INVESTMENT OUTLOOK

Ongoing renegotiation of trade agreements, threats of trade wars, and escalating tariffs on goods imported to the U.S. have battered foreign economies, their currencies, and stock markets this year. Conversely, the pro-growth fiscal cocktail of tax cuts, deficit spending, and decreased regulation have provided an economic boost here at home where the U.S. dollar has risen and U.S. stock markets have appreciated. U.S. job creation this year has continued at approximately the same pace as the last few years<sup>1</sup> and inflation, though increasing, remains somewhat subdued.

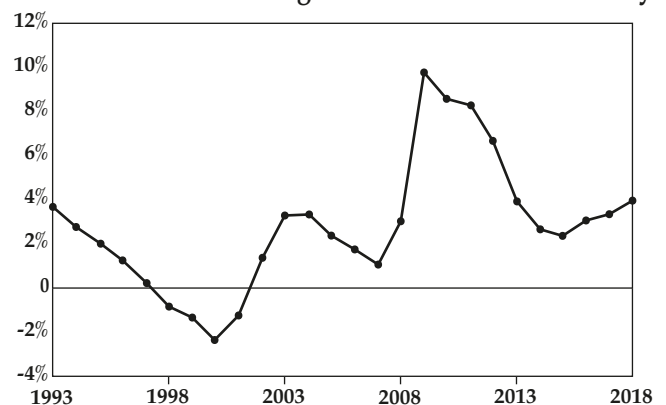
Spurring the U.S. economy is a growing federal budget deficit. (This occurs when the gap widens between decreasing tax receipts to the Treasury and growing federal expenditures.) The deficit during the first 11 fiscal months of 2018 (ending August), at nearly \$900 billion, is 33% higher than the same period one year ago. Increases in fiscal stimulus of this nature are often reserved to help boost an economy out of a downturn. In the past quarter-century, the deficit as a percentage of the overall GDP is higher than any other period excluding the years following the Great Financial Crisis of 2008-2009. Nearly every other time in the past century when this ratio was higher than it is today occurred during times of recession, depression, or war. While it is unusual to widen the federal deficit

this much in times of a non-recessionary economy, the repercussions of expanding the federal budget deficit during a time of economic stability are a topic and problem for another day. Currently, the sun is shining on the U.S. economy.

U.S. stock prices, led by a small number of high-flying stocks, have greatly outpaced their foreign counterparts this year. As a result, the vast majority of investors who have at least a relatively diversified portfolio have lagged the U.S. stock market. Moreover, the direction of stock prices during the last few months has not been favorable to those who invest with even a modicum of caution. That, of course, will change, though the timing is unknowable.

"By some valuation measures," acknowledged the Federal Reserve Chairman, Jay Powell in late September, "[stock price levels] are in the upper range of their historical value ranges." According to Nobel Laureate Robert Shiller's price-to-earnings ratio and Warren Buffett's preferred market valuation indicator, stock valuations throughout history were higher only during the Tech Bubble

## U.S. Deficit as a Percentage of the Overall U.S. Economy



*Cheviot is in its 34<sup>th</sup> 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.*

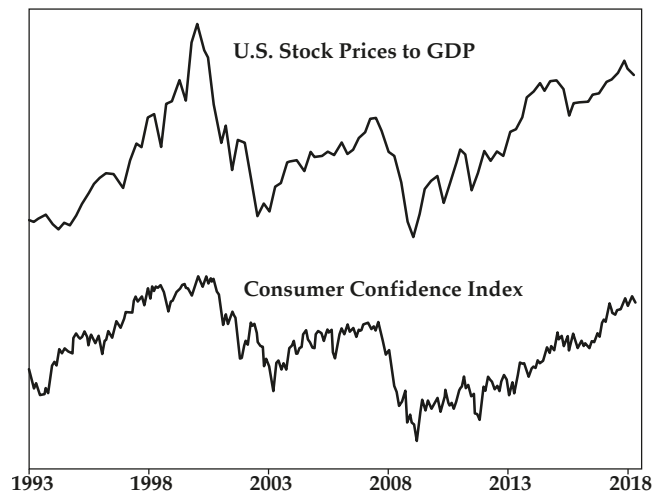
*Cheviot is a completely independent financial advisory firm. We put our clients first in everything we do.*

of 1999-2000. Stock valuations that peaked at the end of the Roaring Twenties and in 2007 take a backseat to the levels of 2018. Market participants and many economists are hopeful that a virtuous cycle of economic growth, higher stock prices, and record-high consumer sentiment will provide the fuel to propel each other higher.

We believe that consumer sentiment in the U.S. is a reflection of the level of the stock market. When stock prices are high, consumers are optimistic about their ability to spend. Seeing one's retirement plan grow in value inspires confidence to spend more – and save less – today. This behavior is described as “the wealth effect” of higher stock prices. So, too, however, does the stock market deplete consumer confidence when market prices fall. See the nearby graph for the tight correlation between consumer confidence and stock prices. Consider this strong relationship and the cyclicity of markets and the economy the next time you hear or read in the financial news that consumer sentiment reached a multi-year low. Such a time may present us with many wonderful opportunities to buy stocks intelligently.

When stock prices are at today's high level, it may be wise not to expect from one's portfolio the same type of growth produced in the last few years. We recall clearly from 1999-2000 and 2006-2007 the rosy future estimates for stock market growth that were made by others in financial planning decisions after several years of rising stock prices, (these estimates fell prey to something called “recency bias”). These were the years just prior to bear markets that forced major downward revisions to consumers' ability to spend. The advice to prepare for a rainy day

### Consumer Sentiment Follows the Stock Market



works best when it is still sunny outside.

The same is true for investing in the stock market (or any asset class) when valuations are as high as they are now. As we have done throughout Cheviot's history whenever market valuations were stretched to the upside, we are on the lookout for storm clouds that could cause market prices to revert lower toward longer-term historical valuations. For now, we are actively patient, studying potential investments and waiting. Conversely, if market valuations were low, we could more safely deploy capital into intelligently-priced stocks. That day will come either from a market-wide downturn, an industry that suffers its own bear market, or a particular company that struggles with bad news. So, while we don't mind the sunshine, we will keep an umbrella within reach.

### WHAT MIGHT THE MID-TERMS MEAN FOR THE MARKET?

For the near-term impact it will have on the direction of the U.S. government, we are curious (to state it mildly) as to what will come of the mid-term elections this November. Many market participants also wonder how the mid-term elections will impact the U.S. stock market.

Currently, and since the beginning of 2017, the U.S. government is “unified,” meaning that the same party controls both the legislative branch, Congress, and the executive branch, the Presidency. Alternatively, the government can be in “gridlock,” which describes a lack of single party dominance over the Presidency and Congress. Within a gridlocked arrangement, there are two possibilities: 1. Presidential gridlock, where one party controls the White House and another party controls both the House of Representatives and the Senate and, 2. Congressional gridlock, where neither party controls both houses of Congress.

Which of these political arrangements might be best for the stock market's future performance? Allowing history to be our guide, we viewed data going back nearly a century. Periods of both presidential gridlock and unification played host to the greatest subsequent stock market returns. Congressional gridlock lagged behind those two *unless* the outlier period of 1930-1932 is excluded. This period marked the depths of the bear market for stocks after the 1929 stock market crash, a three-year grind lower for stock prices that ended in July of 1932. Excluding this unusual period from the average subsequent performance for congressional gridlock and this period's future return was in line

with its political brethren. See the table below:

<i>Government Composition</i>	<i>Subsequent 2-Year Total Return</i>
Unified	16.9%
Presidential Gridlock	16.1%
Congressional Gridlock	5.5%
Congressional Gridlock excl. 1930-1932	16.6%

The mid-terms may usher in a gridlocked government. Historically, when a unified government converts to a presidentially-gridlocked one (where a different party controls the entirety of Congress), future two-year returns have averaged 10.9%. Changes from a unified government to a congressionally gridlocked one ushered in negative 10.5% total two-year return from stocks. This situation occurred only three times since 1928 and included the disastrous 1930-1932 period for the stock market. If one excludes the Great Depression, the average two-year forward return jumps to a positive 14.2%.

This is not to say that we are managing your portfolios any differently due to the potential outcomes of the mid-term elections. To us, the differences yielded by the three types of government are not wide enough, nor do they recur with enough frequency, for us to base investment decisions. In today's environment, we believe the most important drivers of stock prices during the next several quarters will be:

- the impact of trade talks,
- the future level of tariffs,
- the Federal Reserve's rate of interest rate increases in 2019,
- the ramifications of a potentially slowing housing and auto market on U.S. GDP growth, and
- the underlying earnings results of the largest publicly-traded U.S. companies.

While the historical evidence suggests that changes within the composition of government should not vastly alter the future direction of stock prices, there could be circumstances where portfolio changes should be made. At this time, we will stay with high quality companies which we expect to thrive under any of the potential political arrangements voted into effect this November.

#### **YEAR-END FINANCIAL PLANNING CONSIDERATIONS**

In addition to investment management, we frequently help our clients with other important

areas of their financial lives. These matters include estate planning, charitable giving, insurance advice, and more. Some of our clients have asked that we periodically write a few recommendations in this letter, but, because financial planning is personal and specific, there are limits to how specific the recommendations can be to meet the needs of a group comprising diverse individuals. That said, here are some strategies to consider before year-end that may be applicable to your financial situation. As clients, you are always welcome to contact us with specific financial questions, no matter how big or small.

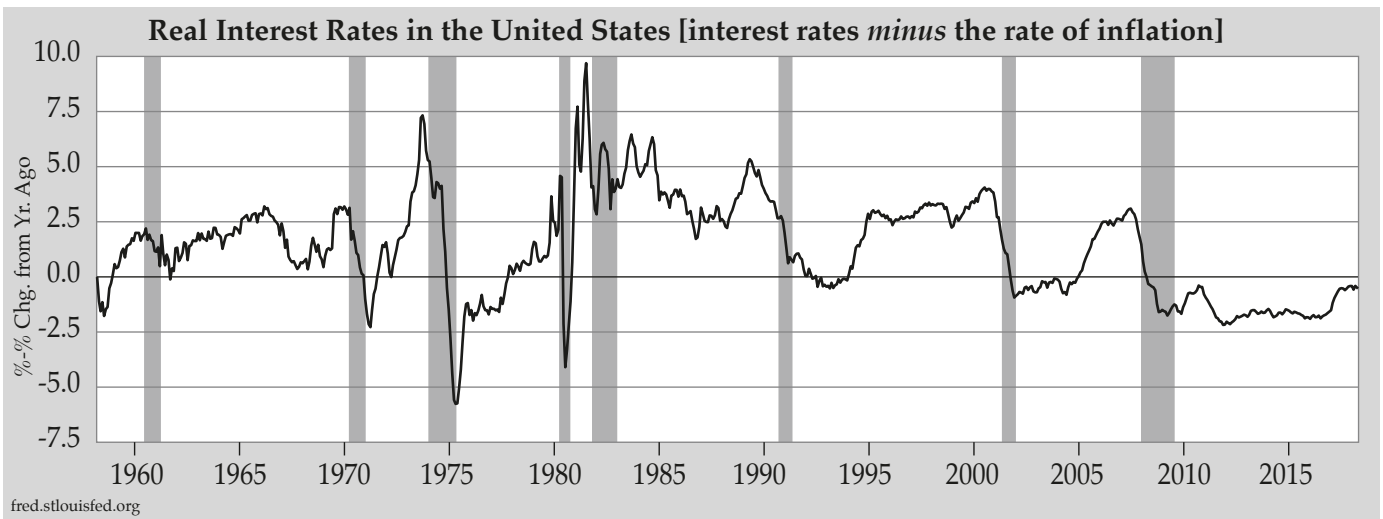
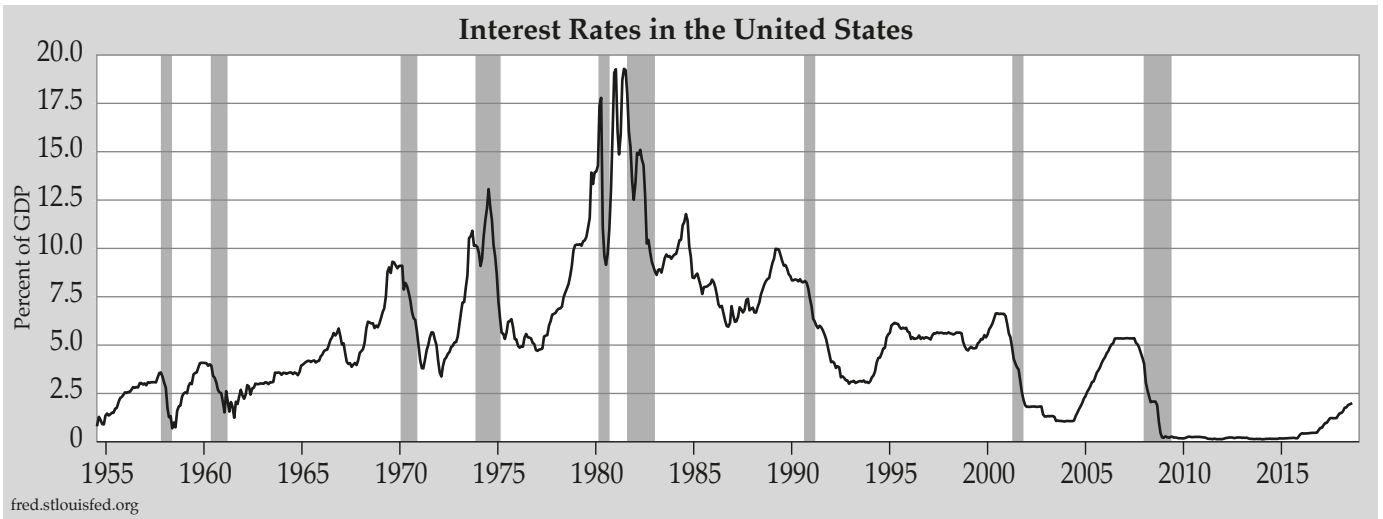
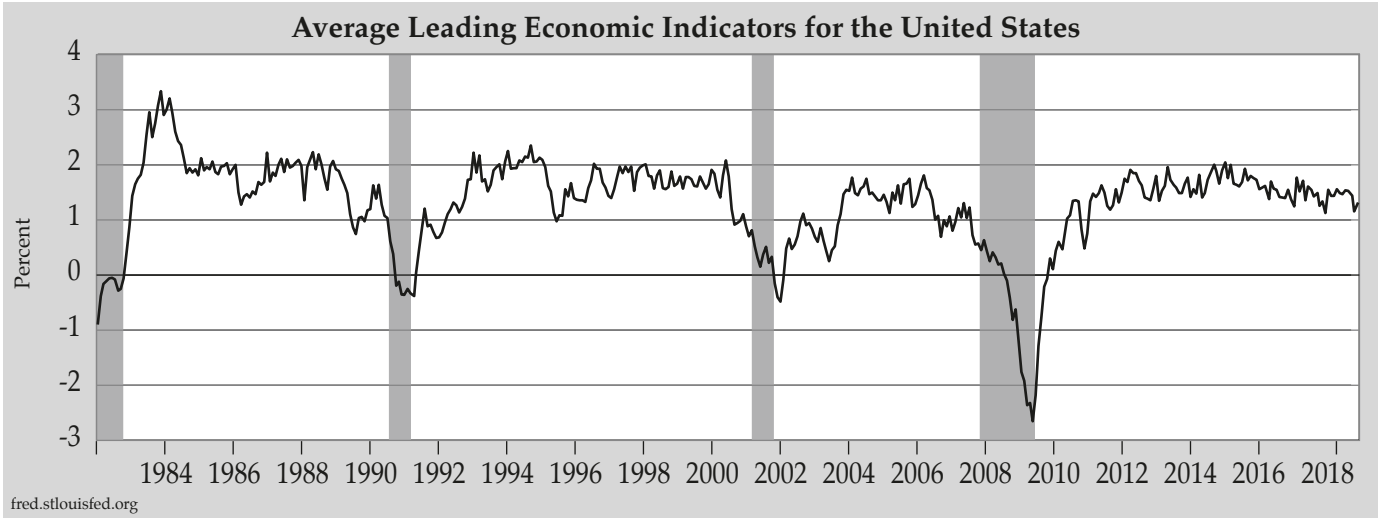
#### ***Make Charitable Gifts***

Most gifts to qualified charities are tax-deductible. Donating before year-end allows the taxpayer to deduct the donated amount in the year of the gift, provided they do not take the standard deduction when filing their taxes. Rather than donating cash, consider donating securities that have appreciated. By donating shares of highly appreciated stock, for example, the donor receives a deduction in the amount of the full fair market value of the security as of the date of donation. This has the dual benefit of avoiding capital gains tax on the appreciated amount of the investment and preserving cash that would otherwise have been donated. Additionally, the same quantity of shares that were donated

*-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.







*-Continued from Page 3*

could subsequently be purchased with a new – and tax-friendly, higher – cost basis.

As an alternative to donating directly to a charity or to multiple charities, donors can establish and donate to a Donor-Advised Fund (DAF). This fund acts as a repository for donated assets to be distributed to qualified charities at a later time. The donor receives a tax deduction for the full amount donated to the DAF in the year in which the funds are donated, even if the DAF distributes the funds over a period of years.

#### ***Make Annual Gifts to Family Members (or Others)***

In 2018, the IRS raised the annual gift exclusion from \$14,000 to \$15,000. This gift amount can be given to as many individuals as you like, without reducing your lifetime gift and estate tax exemption. The gift is tax-free to the recipient, and, while not tax-deductible to the donor, the funds reduce the value of donor's estate and subsequent estate taxes at death. No gift tax return is required to be filed for gifts that do not exceed \$15,000.

#### ***Make Large Inheritance Gifts Over the Next Few Years***

There was a massive jump this year in the gift/estate exemption base, doubling from \$5,490,000 in 2017 to \$11,180,000 in 2018 (couples actually can give double that amount since each person can contribute the new maximum). This means that estates can pass assets to heirs without additional estate taxes under the lifetime limit mentioned above. Because this law is in effect until 2025, (at which time, the gift/estate exemption base could revert to a lower number) individuals with very large estates should consider taking advantage of the current law. For such individuals, it may prove wise to transfer some wealth in the next few years in case this tax law becomes less favorable in the future.

#### ***Harvest Capital Losses Against Taxable Gains***

At Cheviot, we do not advocate allowing taxes to dictate investment strategy. However, we will examine opportunities in the portfolio to offset realized capital gains and the taxes due on them. For example, an investor in the highest tax bracket who sells a stock for a gain within one year of having purchased it will owe roughly 50% of that gain in federal taxes and state taxes. But by selling an equivalent amount of a losing stock, the investor can eradicate the gain and have a resulting tax bill of \$0. If capital losses exceed capital gains for the year, up to \$3,000 of those realized losses can be

used to offset ordinary income (or \$1,500 for married taxpayers who file separately). The remainder can be carried forward to offset gains in future years.

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

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

#### ***If You're 70½ or Older, Don't Forget Your RMDs!***

After age 70½, one must take minimum required distributions from traditional IRAs (including roll-over and SEP-IRAs) and 401(k) accounts (in most cases). Failure to take the required minimum distribution by December 31<sup>st</sup> could subject investors to penalties as high as 50% of the undistributed amount. Cheviot can calculate and facilitate taking RMD withdrawals. Call on us for help.

#### ***Reduce Taxable Income by Making Retirement Contributions***

One of the biggest changes this year to the tax code is the rolling back of long-standing deduction rules, with the standard deduction being nearly doubled to \$12,000 for individuals and \$24,000 for married couples. The higher amount will certainly incentivize many to forgo itemization for the more attractive standard deduction. Individuals whose charitable giving and other deductions exceed the new higher amounts, will continue to itemize, though there are more restrictions on what qualifies. Deductions of state and local taxes are now capped at \$10,000 which is a big deal considering the average claim last year in California was over \$18,000, according to the Pew Charitable Trust. This means that \$8,000 of additional income is subject to ordinary tax rates for the average California taxpayer. There are also changes to the deductibility of some mortgage interest on new loans over \$750,000, as well as tighter restrictions on the deductibility of home equity lines of credit interest. Individuals that foresee large state and local tax bills should strongly consider maxing out retirement plan and HSA contributions to reduce taxable income. One

could even consider negotiating with their employer to reduce their salary and commensurately increase the amount the employer is contributing to their qualified retirement plan. (This also saves both parties payroll taxes.)

### ***You Don't Have to be Behind to Make "Catch-up" Contributions***

If you are older than 49 and still working, there is a good chance you could qualify for "catch-up" contributions. Many hear the word "catch-up" and automatically assume it is only for people who have not saved enough for retirement, but, fortunately, this is not the case. By taking advantage of this powerful IRS rule, your extra contributions to your 401(k)/IRA, Roth IRA, or HSA (if you are 55 or older) can get the reward of tax-deferred growth and, a lower income tax bill this year.

### ***Open a Solo 401(k)***

Self-employed individuals can take advantage of increased contribution limits by sheltering income in a qualified retirement plan, like a solo 401(k). Furthermore, spouses who are on the payroll may also contribute to the plan. Including "catch-up contributions" for participants age 50 and over, a husband-wife team can shelter up to \$120,000 between them in 2018, provided earned income from the business for each is at least \$60,000.

### ***Don't Spend Your HSA Dollars (If You Don't Have To)***

Among the many benefits of a Health Savings Account is that the tax-deductible contributions do not need to be spent before the year's end. In fact, the money can remain in the account and continue to grow tax-free and be withdrawn tax-free when used for qualified medical expenses. Additionally, there are no required minimum distributions (RMDs) from Health Savings Accounts, so if you are able to delay spending the funds, you can get many years of compounded growth. This can continue throughout life, even while the IRS is forcing accountholders to make withdrawals from their IRAs after 70½ years of age. An HSA is perhaps the most tax-advantaged savings tool there is, so – if you are eligible for an HSA – be sure to contribute the maximum amount allowed before the end of 2018.

For all Cheviot clients, we are happy to discuss with you any of these and any other financial planning strategies.

### ***CREDITS***

Darren C. Pollock, David A. Horvitz, Jim Whiting, and Scott Krisiloff 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.

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.

Certain statements included herein contain forward-looking statements, comments, beliefs, assumptions, targets, and opinions that are based on current expectations, estimates, projections, assumptions, targets, and beliefs of the members of Cheviot Value Management, LLC. Words such as expects, anticipates, believes, estimates, projects, targets, and any variations of such words or other similar expressions are intended to identify such forward-looking statements.

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.

The quarterly letter of Cheviot Value Management, LLC, Investment Values, is intended to be a source of educational information to the clients of Cheviot Value Management, LLC about investments and related topics. Comments about specific securities or asset classes are NOT intended to be recommendations that readers purchase or sell such securities or make investment in such asset classes. Nothing in this quarterly report should be construed as an offer to sell or a solicitation to buy an investment security. Any comments related to individual securities are solely intended to explain to clients why such securities may have been or may be purchased or sold within a diversified portfolio such as the portfolios of investment clients of Cheviot Value Management, LLC. Comments about securities not held in portfolios managed by Cheviot Value Management, LLC are purely for educational purposes and are not intended to be recommendations to purchase or sell such securities. Securities mentioned in Investment Values may be purchased or sold at a later date.

Cheviot Value Management, LLC never takes custody of client assets. Assets are always held in the account holder's name(s) at a third-party financial institution. The custodian of record is required under law to regularly provide separate account statements from those received by Cheviot Value Management, LLC. Clients may access their investment portfolios directly through the custodian's website or via the website of Cheviot Value Management, LLC. No personal or financial information of any client will be disclosed by Cheviot Value Management, LLC without the permission of the account holder or unless Cheviot Value Management, LLC is required to do so by law.

Copyright © Cheviot Value Management, LLC. All rights reserved. Reproduction in whole or in part is not permitted without advance written consent. Requests for permission to reproduce any portion of the contents of this quarterly letter may be emailed to [contact@cheviotvalue.com](mailto:contact@cheviotvalue.com) or mailed to Cheviot Value Management, LLC, 9595 Wilshire Blvd., PH 1001, Beverly Hills, CA 90212.

## **NOTES**

<sup>1</sup>The U.S. economy created slightly less than 200,000 jobs per month on average during the past 20 months compared with an average of slightly more than 200,000 jobs per month in the 20 months ended December 2016.

## 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 well 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.

9595 WILSHIRE BLVD., PH 1001, BEVERLY HILLS, CA 90212  
www.cheviotvalue.com (310) 451-8600 contact@cheviotvalue.com