

# INVESTMENT VALUES

Issue Number 129, January 2019

*“The object of life is not to be on the side of the majority, but to escape finding oneself in the ranks of the insane.” - Marcus Aurelius*

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## OUR INVESTMENT OUTLOOK

Markets entered 2018 on a high note, strong sentiment propelling stocks higher immediately as tax cuts in the U.S. were expected to cause a cascading windfall of prosperity throughout the economy. While this served to boost economic growth in the U.S. for the year to more than 3% for the first time since 2005, the sugar high from lowered taxes wore off by year end. Markets ended 2018 in decline as softening economies throughout the globe and rising interest rates in the U.S. finally mattered to investors. Falling market prices sent a clear message to elected officials that there are no winners in a trade war.

For the full year, the breadth of market price declines was more widespread than any other year in history; nearly every asset class and region across the globe were lower. U.S. stocks, as measured by the S&P 500 fell by 4.4% but U.S. corporate bonds also were down more than 2% and commodities declined by nearly 11%. Global, non-U.S., stocks fell by 10% as the Chinese market declined by 14% and both Germany’s and Japan’s markets were clipped by the same 18%. For investors in 2018, there was no place to hide.

For the markets, as the year gracelessly came to an end, U.S. stocks, depending on the index, declined briefly by 20% or more, an amount considered to be a bear market. Leading to the market’s low point

was an attempt by the U.S. Treasury Secretary, Steve Mnuchin, on vacation and from the beaches of Cabo San Lucas, to reassure U.S. markets. On a Sunday evening, he took to Twitter to announce that all was fine with the largest U.S. banks, they had sufficient capital to conduct business without constraints. Market participants had not been worried about this, however, and showed their curiosity of why such reassurances were necessary by sending stocks lower by nearly 3% (or a headline-grabbing 653 points for the Dow).<sup>1</sup>

That night, a call was made from the White House to an as-yet-unnamed hedge fund manager to ask what could be done to end the market’s decline and cause stocks to rally again. Simple advice was given: end the trade tensions with China and have President Trump stop badgering the Chairman of the Federal Reserve. The Chairman, Jay Powell, was already being pressured by a declining stock market – a decline some might say he helped cause.

On October 3rd, Powell stated that interest rates were “a long way” below the Fed’s range of where they would be considered neutral (a magical level created by economists where they believe that interest rates would produce economic growth that is neither too hot nor too cold or, as Goldilocks would say, “just right”). Investors interpreted this to mean that interest rates had much further to rise, which would be negative for the economy and stock prices, and thus sellers stampeded through the stock market. After nearly two months of turbulence, in late November Powell tried to extend an olive branch to the markets, suggesting that interest rates were actually “just below” the neutral rate. Powell’s attempts were unsuccessful and so on December 19th he tried again to soothe markets. He commented, however, that another form of the

*Cheviot is in its 35<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.*

Fed's measures to raise interest rates, "quantitative tightening" (the opposite of "quantitative easing" that was used to propel markets out of freefall one decade ago) would continue "on automatic pilot." Stock selling gathered steam, the market sending an unhappy signal to the relatively new Chairman.

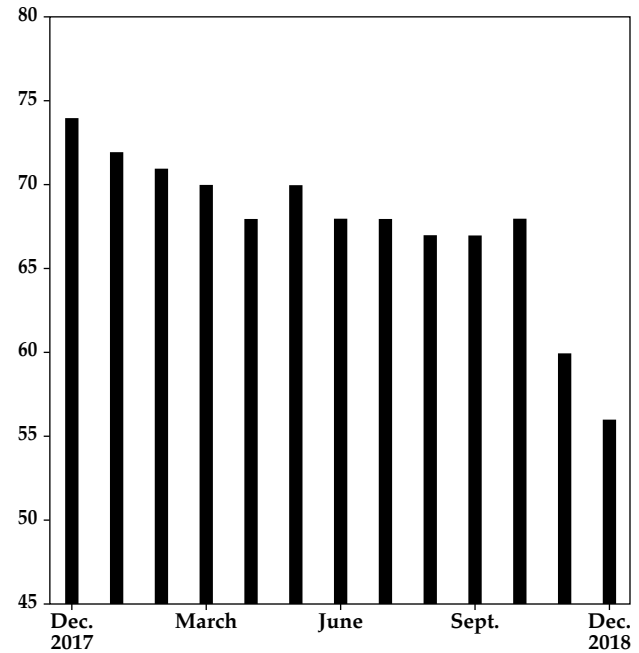
Powell got the message. On January 4th of the new year he, with former Chairs Ben Bernanke and Janet Yellen by his side, adjusted his position from two weeks prior. If quantitative tightening were causing problems in the economy, "We wouldn't hesitate to make a change." In nullifying the concept of raising rates by way of "automatic pilot," Powell finally communicated a bullish message to the markets. Within weeks, the Fed had shifted the discussion from a question of how many rate hikes it will push through in 2019 to a more supportive tone, one that implies the Fed is aware that its rate hikes may have, at least temporarily, approached their limit.

If escalating trade tensions were the growing pile of kindling, fears of an overzealous rate hike campaign were the match poised to send it ablaze. Various industries the world over faced worsening economic conditions as the fourth quarter wore on. "One of the things that worries me is just how fragile we seem to be to small rises in interest rates," says hedge fund legend Jim Chanos. "Something seems to be a little bit off that eight or nine years into a recovery we can't handle [it]... If rates were to go to 5%, I think people would lose their minds." They would lose tremendous value in their investments and home equity, too.

To Powell's credit, perhaps he and the Fed recognized that the steady march higher of interest rates was causing consternation in the housing market. The point at which mortgage rates above current levels could cause a meaningful slump in the housing market may be near. Homebuilder confidence, reflecting demand for new homes, plummeted in the last few months after reaching an 18-year high entering 2018. The rapidity of the decline paralleled prior shifts that presaged larger housing market downturns. This is important because housing activity in the U.S. strongly impacts the greater domestic economy.

The near- to intermediate-term investing environment may be different than the one investors faced during the last couple of years, a time marked by decreasing economic regulation and the one-time boost of dramatically lower corporate taxes and lower personal tax rates for most Americans. Additional fiscal stimulus may now be harder to generate at

## Homebuilder Confidence Plummets



just the time when the U.S. manufacturing sector has begun to slow.

Though new challenges to the investment landscape may be with us for a while, many time-tested principles of investing will still apply: Own high-quality companies that can withstand greater amounts of economic turbulence. Maintain an appropriate balance within one's portfolio of companies, industries, and assets that are not strongly correlated with each other. Be intelligently diversified but not indiscriminately so. Ignore fluctuations in the market with equanimity and make such fluctuations your friend (as they may present you with intelligent opportunities) rather than your enemy (when emotional decision-making gains control).

And remember the words of mutual fund legend Peter Lynch: "Whatever method you use to pick stocks... your ultimate success or failure will depend on your ability to ignore the worries of the world long enough to allow your investments to succeed. It isn't the head but the stomach that determines the fate of the stock-picker."

## CRYPT-UH-OH-CURRENCIES

We devoted the majority of the space in our January 2018 edition of this quarterly letter to describing what we called "Bitcoin and the Cryptocurrency Craze." (See the Publications tab at [www.cheviot.com](http://www.cheviot.com) or we can send you a copy.) The purpose of that letter was to warn our clients of the immense danger inherent in speculating

in cryptocurrencies. One year later, the prices of various cryptocurrencies have collapsed by more than 80% and, at least for now, the historic crypto-bubble has burst.

As a reminder, the most well-known cryptocurrency, Bitcoin, was created in 2009 as a means to having a global currency independent of any government, transportable worldwide both securely and anonymously and without the oversight or control of banks or regulatory bodies. The digital currency would be supported and its integrity kept intact by the underlying blockchain technology that would enable crypto transactions to be secure and records kept in a distributed and immutable way. It was reasonable to find this concept alluring. Some proponents of cryptocurrency called it the greatest invention since... well, ever.

Combining the currency's mysterious origination (it's unknown for certain who invented Bitcoin) with its rebellion against established governmental and financial institutions, cutting edge and nearly inexplicable supporting technology, and a rising price in various cryptocurrencies themselves, and we had the makings for what became one of the greatest bubbles in financial history.

Despite the crypto-crash, bruised but undeterred proponents of the new-age currency remain. The calls made very near that December 2017 peak for Bitcoin to soar to \$1 million per coin have quieted but others see future utility for the digital concept. Mike Novogratz, a former partner at Goldman Sachs and hedge fund manager, is one of crypto's biggest bulls. Novogratz said recently, "When you're in the speculative mania, testosterone is boiling over and there's a lot of greed. The audience is more sober now, the drug is gone. If anything, we're on the other side, at the stage where there's the pessimism, and the fear, and the 'Oh my God, it's going to zero.' But it's not going to zero." He expects virtual worlds to flourish online, supported by blockchain technology and employing cryptocurrencies.

On the other side of the coin (sincerest apologies for the pun), is Jamie Dimon, CEO of JPMorgan, who last year said: "You can't invent a currency out of thin air and think that people who are buying it are really smart." Obviously, Jamie Dimon, as CEO of one of the world's largest banks, has skin in the current game where government-backed fiat currencies reign supreme over other forms that may exist in the future. Such a conflict easily enables crypto enthusiasts to dismiss his opinions that

cryptocurrencies are a "fraud" and to brush aside the views of others like Warren Buffett who has called them "rat poison squared." (If that sounds harsh coming from the usually folksy "Oracle of Omaha," perhaps he grew tired of quotes like this from Fidelity fund manager Mark Schmehl, who said near Bitcoin's peak: "I don't believe in Warren Buffett. I care about new things, things that are innovative," and not what Buffett believes in, which he called "total baloney.")

At the risk of sounding to those bullish on cryptocurrencies like old-fashioned luddites, we at Cheviot remain skeptical that cryptos will soon be widely embraced as a true form of currency. As a store of value its prices are far too volatile (imagine the dollars in your pocket fluctuating higher and

lower by several hundred percent in the past year). There are still far too many crypto choices available. Like other currencies, they are portable – electronically – but crypto can be hacked

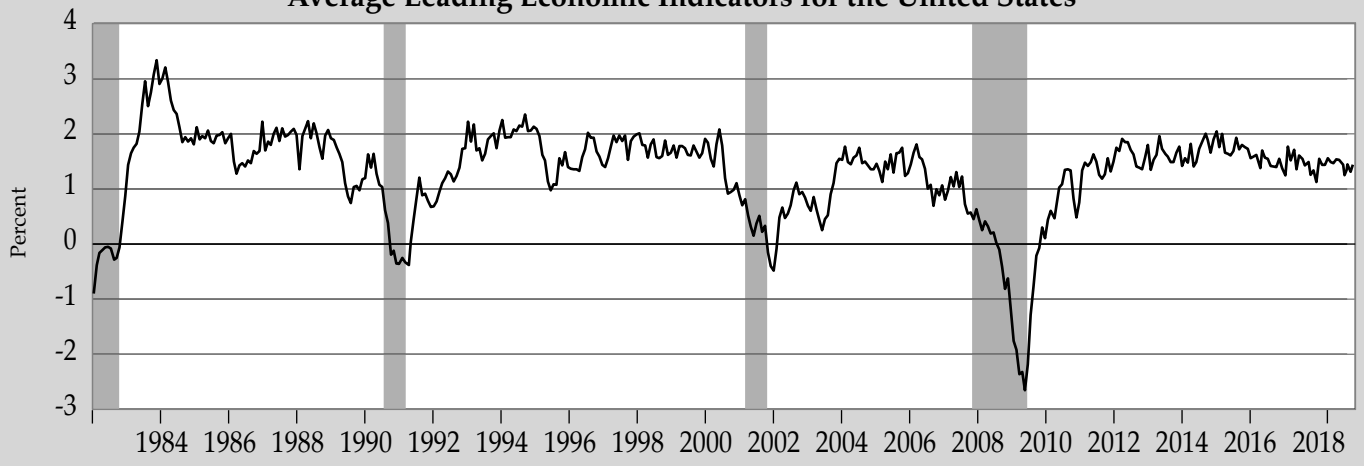
and, just like clumsy old cash, stolen. The scarcity of each cryptocurrency is no more trustworthy than a government that promises not to increase its money supply. Cryptocurrencies are likely not going to be a suitable and widely accepted method of payment until the significant kinks listed above are ironed out.

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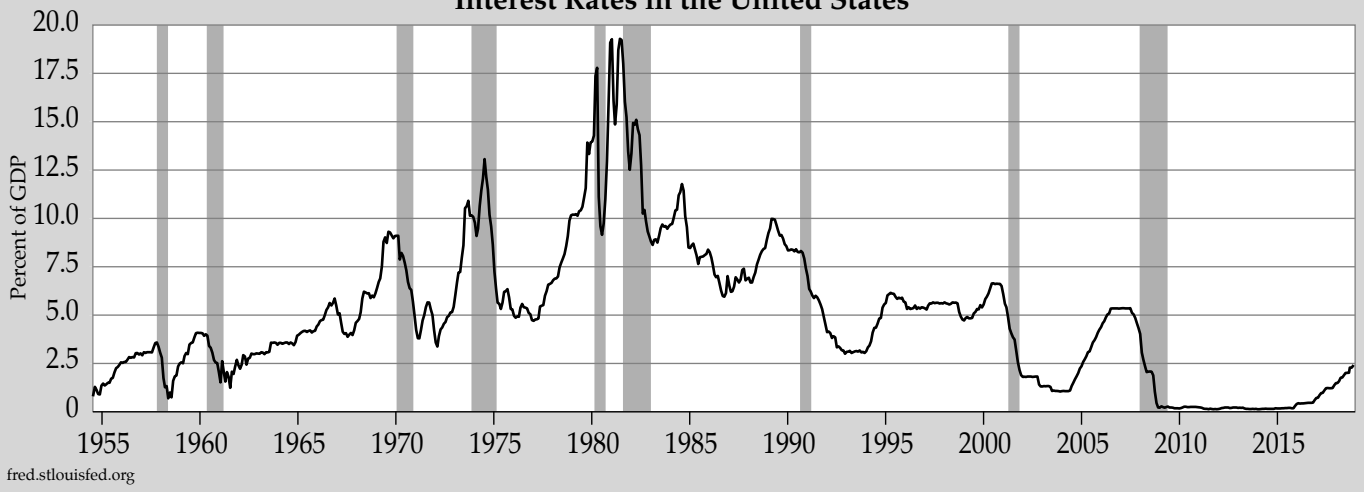
### ON THE NEXT TWO PAGES...

...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.

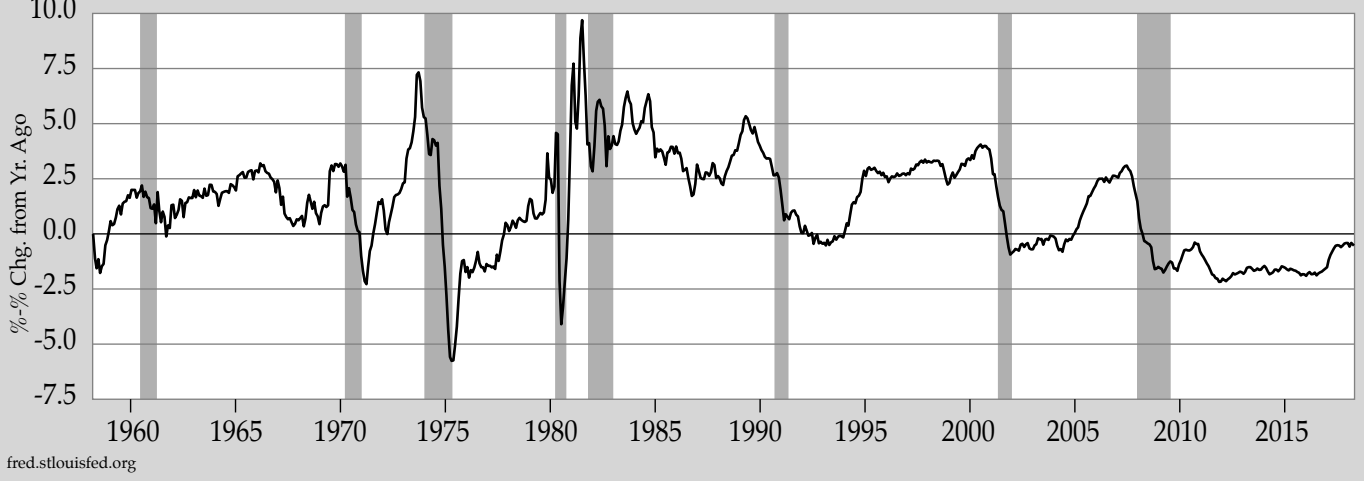
Average Leading Economic Indicators for the United States

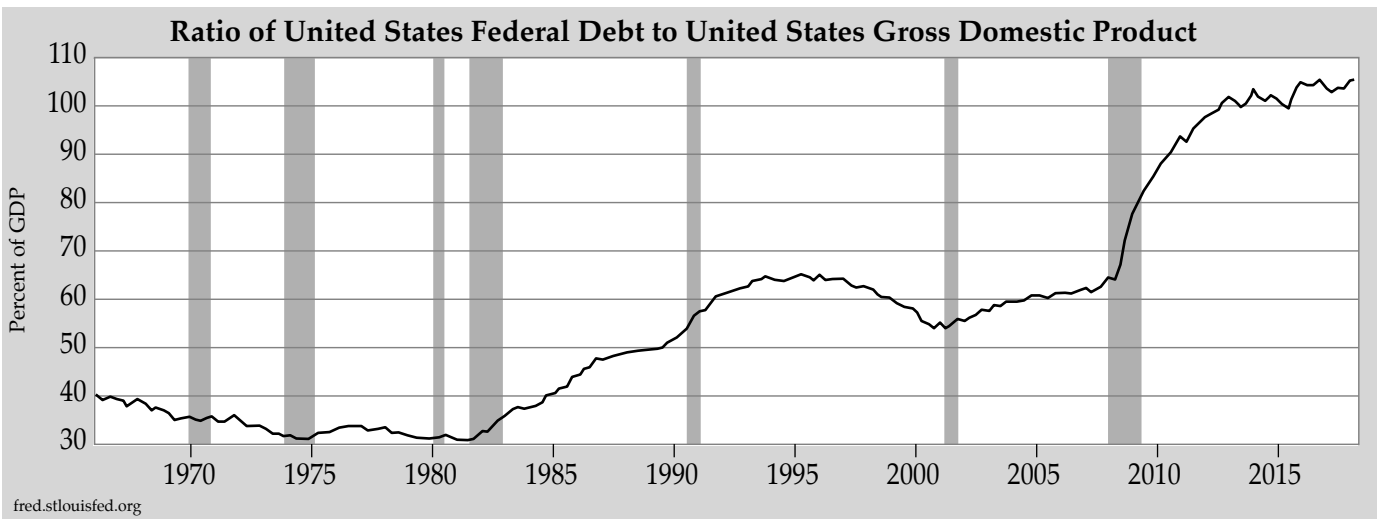
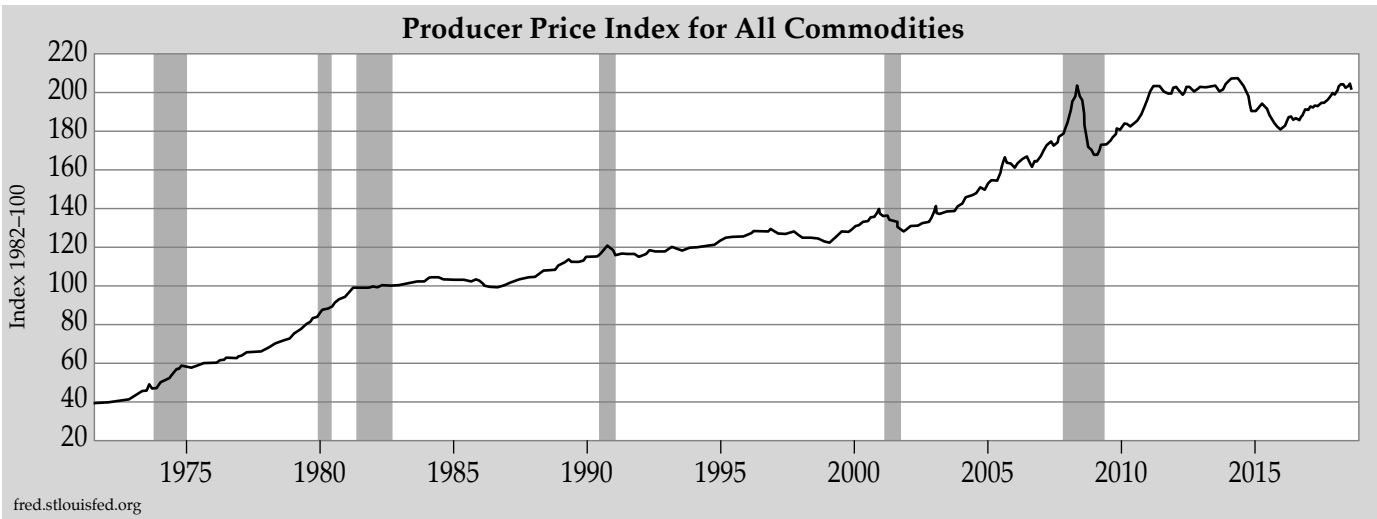
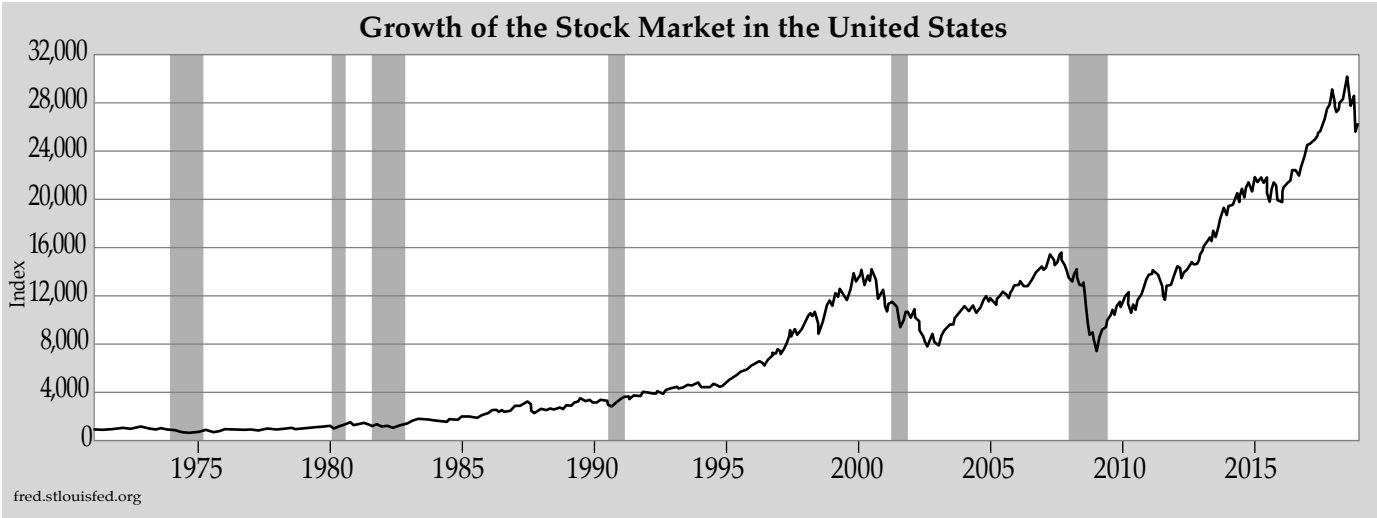


Interest Rates in the United States



Real Interest Rates in the United States [interest rates *minus* the rate of inflation]





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No matter how great the story of an investment, an investor cannot consistently buy what merely is popular and expect his or her investments to do well: what is popular is, at best, fully priced and, at worst, dangerously overpriced. At its peak and for a brief period of time, cryptocurrencies shared the rarified air of wildly overpriced real estate prices in 2007 and bubbly tech stocks in 1999-2000. During a span of three weeks in December 2017 – which prompted our writing the January 2018 warning – our office fielded a small number of phone calls from clients who had questions about cryptocurrencies. For our carefully-selected cadre of clients who are of like minds as us, this was a deluge of phone calls, for Cheviot an historic act of collective curiosity reminiscent of the aforementioned housing and tech bubbles.

Buffett likes to describe the natural urge to gamble on something when others are seemingly getting rich at it. “Your wife says, ‘You’re smarter than he [your neighbor] is and he’s richer than you are, so why aren’t you doing it?’” As we hear more stories of large sums lost, we are pleased that our clients were spared the dramatic losses from speculating in cryptocurrencies when they were most popular.

By the very nature of their prices being 80% to 90% lower than when we penned our original warning in December 2017, one might think crypto currencies could again be a good buy. But we remain bearish. At this time, the lower price of cryptos notwithstanding, the fundamentals of the investment remain flawed and unappealing to us. We do not believe that the price decline compensates potential

buyers enough for the ongoing fundamental risks.

Still, last year’s crypto crash is, in our opinion, unlikely to represent crypto’s last hurrah. (In mid-2011, during a prior and much less ballyhooed crypto-mania, the price of Bitcoin ballooned from less than \$1 to nearly \$30 then back down to \$2 all within a few months.) We would not be surprised to see crypto prices rise and fall again, perhaps spectacularly so and several more times. But, without a history of market-produced correlations with other assets or accepted measurement of underlying intrinsic value, there remains to us no convincing way to base one’s valuations on the various cryptocurrencies. Thus, for at least the foreseeable future, the purchase of crypto will remain a speculation – not an investment. It will be a speculation on the allure of the crypto concept and the belief by digital currency devotees that a growing number of people will buy into that concept.

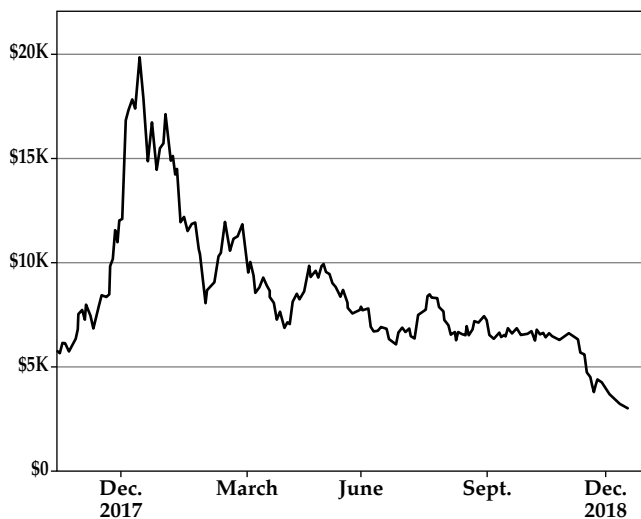
### JANET JOINS THE CLUB

Two pieces written in our July 2017 quarterly letter described the differences in view and tone a Fed Chair takes when they are in office versus being former Fed leaders. Our letter titled, “Cheerleader No More” described how Ben Bernanke, after leaving his post as Chairman of the Fed, removed his rose-colored glasses and became more candid with respect to the U.S. economy. Alan Greenspan, before Bernanke, was notorious for singing the praises of the U.S. economy during the late 1990s boom that went bust and, since his tenure with the Fed, has consistently struck a more somber note.

The other portion of our July 2017 letter that relates to this phenomenon was a brief piece titled, “Say it Ain’t So, Janet!” and described how the otherwise measured Fed Chairwoman, Janet Yellen, tempted fate by saying that she did not believe that there would be another financial crisis “in our lifetimes.” Granted, she made no mention of how long she expects everyone to live but we sensed that a period of stable economic times bred within her a level of complacency that often is surprised when uprooted by unstable times.

Or maybe it was the rose-colored glasses. We said then that we looked forward to when she would be free to comment more candidly about the state of the U.S. economy and, apparently, that time came this past December, less than twelve months removed from her post as Chairwoman. When asked how the financial system compares to that of ten years ago, during the Great Financial Crisis, Yellen had this to say:

**The Bitcoin Bubble**



“Things have improved but I think there are gigantic holes in the system. The tools that are available to deal with emerging problems are not great in the United States.” Yellen continued, “I’m not sure we’re working on those things in the way we should, and then there remain holes, and then there’s regulatory pushback. So I do worry that we could have another financial crisis.”

The rose-colored glasses, already off, were then stepped on: “Corporate indebtedness is now quite high and I think it’s a danger that if there’s something else that causes a downturn, that high levels of corporate leverage could prolong the downturn and lead to lots of bankruptcies in the non-financial corporate sector.”

As of year-end 2007, just prior to the Great Financial Crisis of 2008-09, there was \$3.35 trillion of corporate debt outstanding. As of September 30, 2018, that figure had grown by 86.27% to \$6.24 trillion. U.S. GDP grew by less than half that rate, 40.74% during the same period. Corporate debt as a percentage of U.S. GDP at year-end 2007 was less than 23%; as we entered the fourth quarter of 2018 it was more than 30%, a record-setting figure.

But worry not, said current Fed Chairman, Jerome Powell, in late September: “There is no reason to think this [economic growth] cycle can’t continue for quite some time, effectively indefinitely.”

*Indefinitely?*

Almost immediately, and as if on cue, data pointing to a softening economic climate started to arrive. And that data continued all the way through the end of the year. Powell is learning his way through a more measured version of “Fed speak” and we give Powell the benefit of the doubt. When referring to the length of the current economic expansion, we assume his definition of “indefinite” to mean “unknown” as opposed to “unlimited.”

## CREDITS

Darren C. Pollock, David A. Horvitz, Jim Whiting, and Scott Krisiloff, CFA authored this issue of *Investment Values*.

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## NOTES

<sup>1</sup>Secretary Mnuchin’s reassurances were akin to a commercial airline pilot turning on the loudspeaker mid-flight to tell its passengers, “I just checked the fuel situation and I’m told everything is fine.” The passengers would think, “That’s great but I never had any doubts that you filled up the tank before lift-off. Now what else should I be worried about?”

## 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.

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We give our clients peace of mind through safety-first investing, long-term growth, and a steady stream of retirement income. Cheviot prides itself on meeting the long-term financial goals established with our clients and on providing attentive and personal service.

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#### ***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.

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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.

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