CHEVIOT VALUE MANAGEMENT, LLC

INVESTMENT VALUES

Issue Number 130, April 2019

"There's no such thing as a value company. Price is all that matters. At some price, an asset is a buy, at another it's a hold, and at another it's a sell." - Seth Klarman

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THE 2009 BEAR MARKET BOTTOM: 10 YEARS LATER

Early in 2019, after recent economic data was softer than expected, the Federal Reserve capitulated to pressure from the White House and the stock market's mini-meltdown in the fourth quarter. Near the start of the quarter, the Fed communicated to the financial markets to expect no rate hikes in 2019. This was lowered from expectations in December 2018 of three rate hikes for this year. Higher rates are viewed as negative for stock prices as they slow economic activity (particularly for heavily indebted economies as in the U.S.) and increase the yields on some investments that compete with stocks for one's investment dollar. After falling 13% in the fourth quarter, the about-face by the Fed caused the U.S. stock market to rebound in the first quarter by a similar amount.

A decline of 13% reminds us of the first quarter of 2009, when the U.S. stock market declined by that same "lucky" figure. Yet, in March of 2009, that decline marked the *end* of a terrifying period for investors. The ensuing ten-year bull market has been the longest in U.S. history and has smoothed over many market participants' memories of the fear that occurred during the last large-scale market panic. If one believes that the market correction in the fourth quarter of 2018 was harrowing, there are lessons to be learned.

As the 2008-09 financial crisis and bear market raged through the economy and financial markets, economists predicted protracted economic slowdowns, even lengthy depressions. At their nadir, market prices in the U.S. had fallen nearly 57% from their peak. 85% of the world's largest mutual funds and ETFs declined by well over 50%; many fell by *more than 60%*. Riskier markets throughout the world experienced even larger declines. As happens when markets decline, those who were invested in the most popular securities suffered severe losses.

When it seemed as if prices would fall indefinitely, investors commonly felt that they were far too heavily invested in stocks. The decline in value in their portfolios kept many awake at night. During the panic of 2008-09, many sellers – to their detriment – heeded J.P. Morgan's possibly apocryphal advice given generations ago: *"Sell to the point of sleep."*

For the great majority of market participants, it was far more psychologically soothing to be a seller than a buyer. Even though Cheviot navigated the market upheaval quite well (producing a percentage decline averaging in the single digits for the year 2008), words in this letter cannot do justice to the sheer panic felt by other market participants.[1]

In March 2009, stock market sentiment gauges registered 70% of market participants as bearish, the most dour figure in several decades. Ten years later, this past March, those designating themselves as bearish comprised a mere 27% of the market. Rising stock prices, in this case a rebound to near-record levels, always cause bulls to outnumber bears.

More important than prices themselves, stock market valuations in March 2019 are in the

Cheviot is in its 35th 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.

stratosphere compared with March 2009. Various measures of valuation, from the price-to-earnings ratio (the Shiller P/E), price to sales, the value of all U.S. stocks relative to the value of U.S. GDP (see nearby graph), to the total cost to buy the entire market versus its underlying asset values (Tobin's Q) all have soared. The market's dividend yield is nearly half what it was. See the table below.

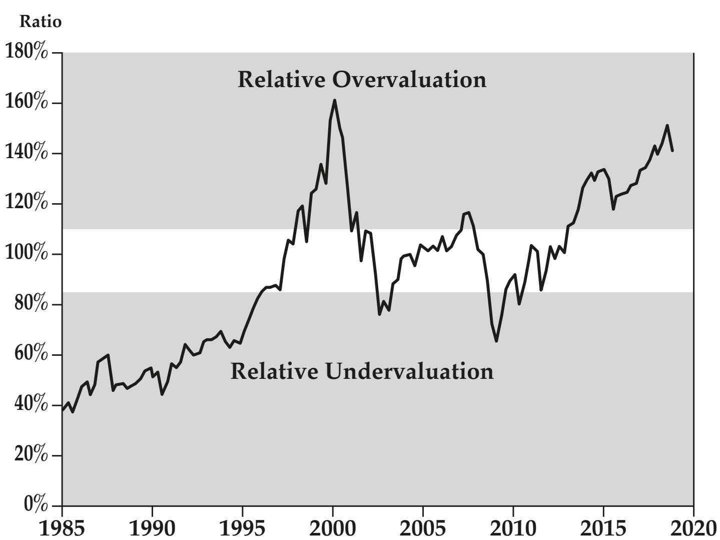
"You pay a high price for a cheery consensus." – Warren Buffett

	March 2009	March 2019	Change
Shiller P/E	15	30	+100%
Price to Sales Ratio	80%	214%	+168%
Market Cap to GDP	66%	141%	+114%
Tobin's Q	59%	117%	+98%
S&P 500 Dividend Yield	3.5%	1.9%	-46%
Investor Sentiment	70% Bearish	27% Bearish	-61%

Today's bullish stock buyer gets far less per invested dollar than most other times in market history. And similar to prior high levels in the market during the past 25 years, today's investor holds more stocks and more index funds than may be wise. Rising prices inflate the confidence of investors, often causing the balance in one's portfolio to be too heavily skewed toward stocks. This optimism and relatively aggressive investment positioning will be tested in the next bear market.

Future investment returns are a function of not just *what* the investor buys but the *valuation* the investor pays for the investment. Just as future returns from low valuations are likely to be strong, future returns from high valuations are likely to be weaker than many expect. We believe the buyer of index funds, which makes an investment in the *entire* stock market – relative to that of carefully-selected individual securities – is likely to be disappointed in coming years.

Value of All U.S. Stocks to the Value of U.S. GDP



Today's high valuations are not permanent (see nearby graph). As Charlie Munger says in the next section, "Valuations will [continue to] go up and down *because they always have*." And along the way, there will be individual companies that suffer through difficult periods, causing their share prices to decline potentially to bargain levels. Should such a company have excess capital on hand after providing for investing in its own business, we hope they will repurchase their shares in the market – particularly if they are companies that we own. When a company in which we are invested repurchases its own shares, our ownership increases without our having to part with any money.

Share buybacks are a hot political topic lately. When a company repurchases shares from selling shareholders – as buybacks do – it helps to circulate money through the financial markets that would otherwise rest idly on the repurchasing company's balance sheet. Share buybacks are most optimal for the repurchasing company and its continuing shareholders when purchases are made at intelligent prices. When the price paid is too high, the repurchase is more likely to be at best disappointing and at worst money-losing – in the same way that it would for the individual buyer.

Counterintuitively for us value investors, the popularity of share buybacks – like investments in index funds – grows with the overall increase in confidence brought by higher market prices. Buyers of shares, be they corporations or individuals, should more closely try to emulate Warren Buffett's advice: "Be greedy when others are fearful and fearful when others are greedy." Those individuals who have been with us for many years, even decades, know that this is one of Cheviot's guiding investment mantras.

THE WISDOM OF CHARLIE MUNGER, 2019 EDITION

Charlie Munger, now 95 years old and 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 https://cheviot.com/articles/darren-sits-down-with-charlie-munger or we will send you the letter upon request.)

This past February, as Chairman of Daily Journal Corporation ("DJCO"), Charlie answered questions for two hours during DJCO's annual meeting and for thirty minutes on CNBC. Topics ranged from the secrets of his investing success to the future direction of wealth inequality in the U.S. and even why Warren Buffett is richer than he is.

In financial markets, many investors seek activity – buying and selling in their portfolio. Charlie and Warren always take a more measured approach. They focus on the quality of opportunities, not the quantity:

"If you actually figured out how many decisions were made in the history of the Daily Journal Corporation or the history of Berkshire Hathaway, it wasn't very many per year. It's a game of being there all the time and recognizing the rare opportunity when it comes and recognizing that a normal human life does not have very many.

"At a place like Berkshire Hathaway, or even the Daily Journal, we've done better than average and now there's a question: why has that happened? The answer is pretty simple. We tried to do *less*… We never thought we could get really useful information on all subjects like Jim Cramer [of CNBC] pretends to have. We always realized that if we worked very hard, we could find a few things where we were right and the few things were enough."

Being very selective meant being able to say "no" to most investment opportunities. Buffett says Munger was skilled at this, referring to him as "the abominable no man."

"It isn't that we were so good at doing things that were difficult. We were good at *avoiding* things that were difficult and finding things that were easy."

Warren and Charlie believe it is wise to read a lot, think a lot, but actually do very little. For the last part, they have a trick:

"Part of our secret is that we don't attempt to know a lot of things. I have a pile on my desk that solves most of my problems. It's called the 'too-hard pile' and I just keep shifting things to the too hard pile. Every once in a while, an easy decision comes along and I make it. That's my system.

"Part of our common sense is just to refer a lot of the stuff to the too-hard pile."

Market prices and valuations are elevated – and have been for the last few years. This is true in the market for stocks, real estate, and various other asset classes. Charlie reminds investors that returns from higher prices are less rewarding than gains achieved from lower prices.

"My advice for a seeker of compound interest is to reduce your expectations, because I think it's going to be tougher for a while and it helps to have realistic expectations – it makes you less crazy."

Given high current valuations will there be no more great opportunities in the future?

"Well, not *forever.* I think it isn't like the last recession [2008-2009] or the last big opportunity that the world is ever going to get is past. There will be opportunities in the future. There are times where they're easier, and there are times when they are harder. Now is tougher. A) the valuations have come up. And B) the competition sorting through those opportunities is more

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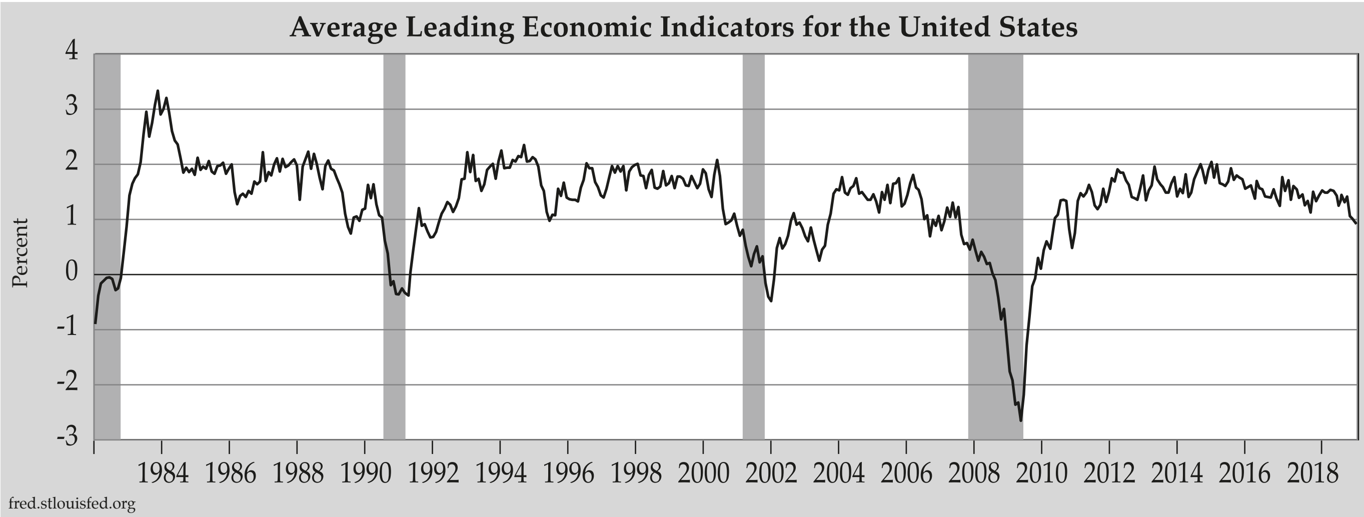
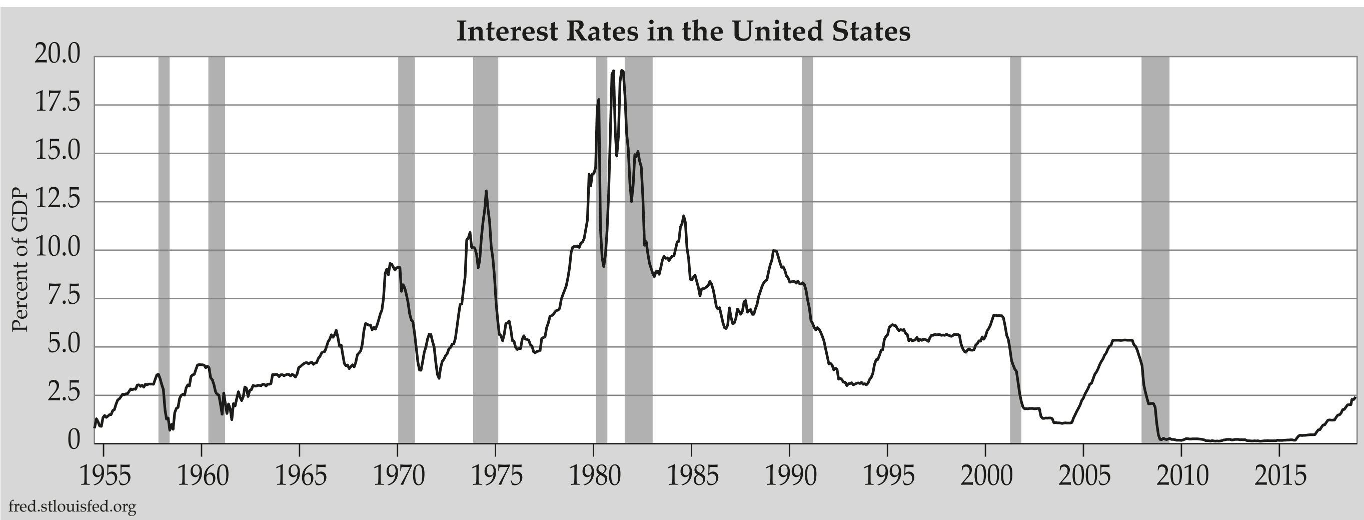
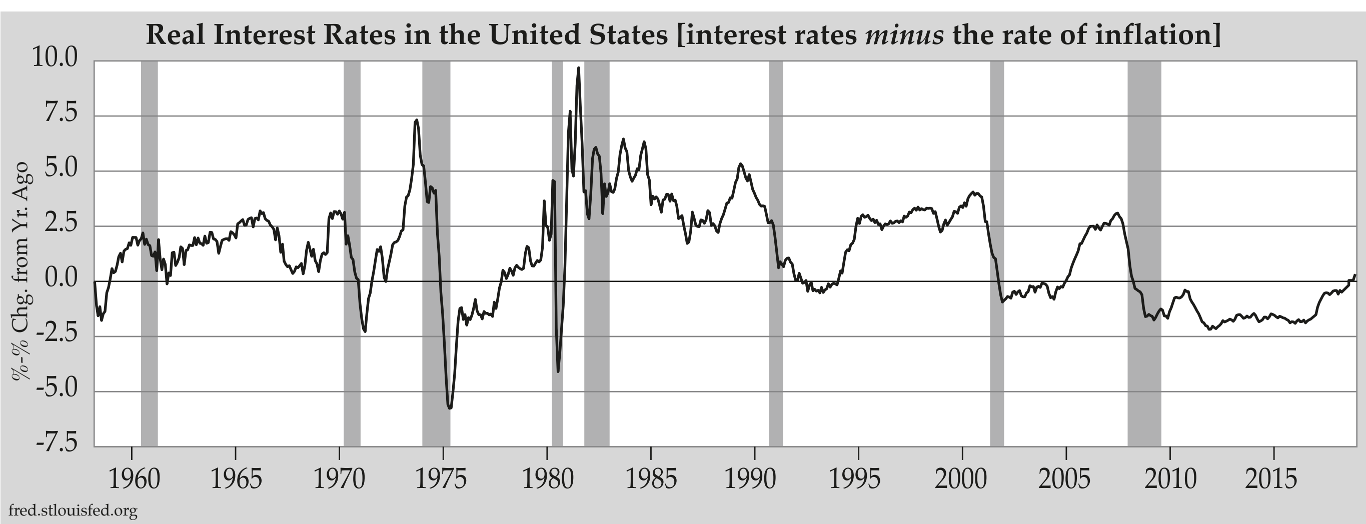
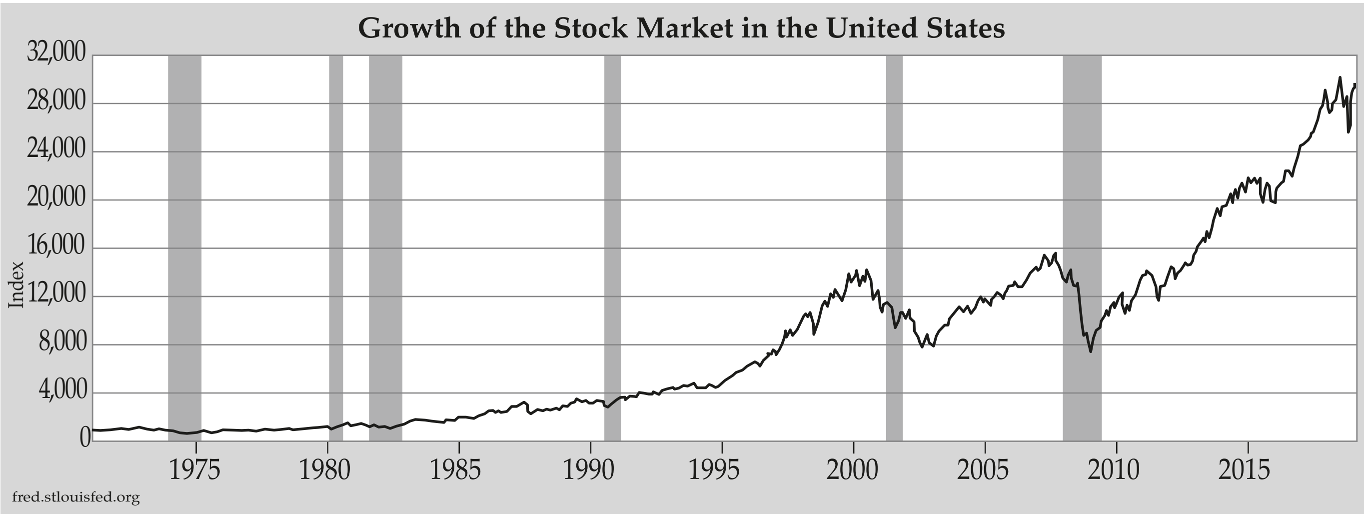
ON THE NEXT TWO PAGES…

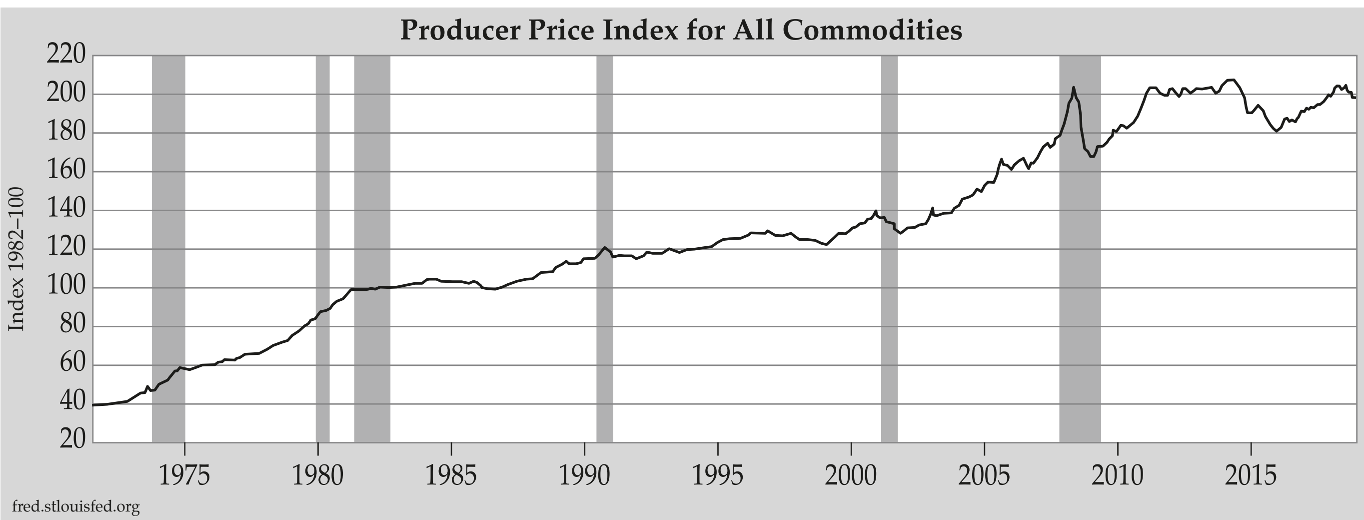
…We share a small sample of graphs that we believe paint a broad picture of U.S. economic activity and sentiment. Graph 1, Average Leading Economic Indicators, compiles ten important economic data points, including those related to manufacturing, employment, and consumer sentiment. Graph 2, Interest 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.

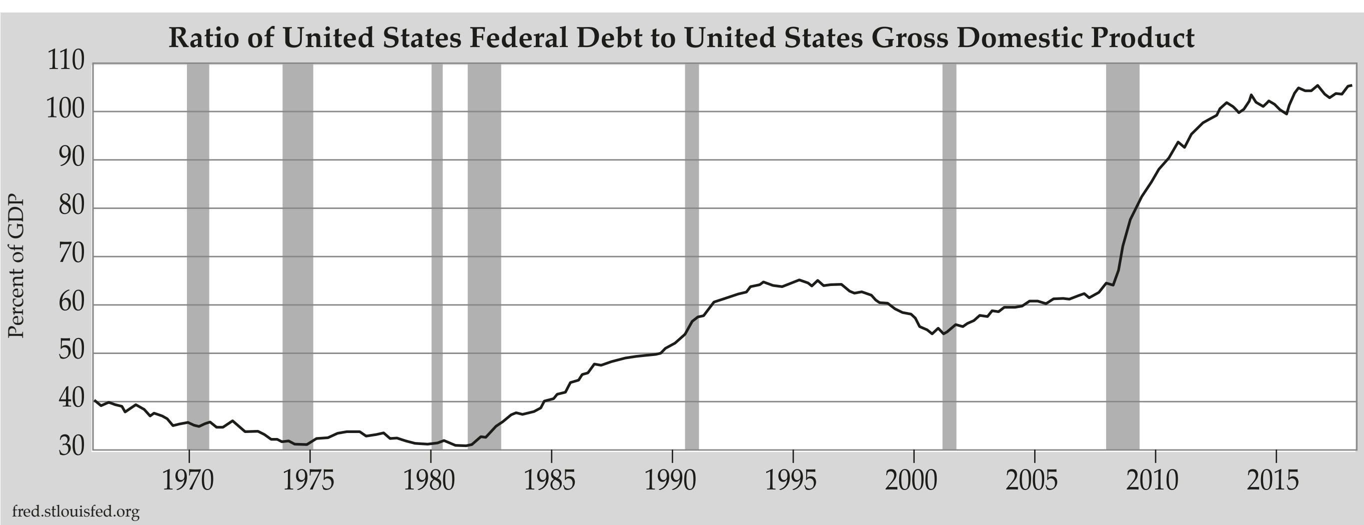

Average Leading Economic Indicators for the United States
Percent
4
3
2
1
0
-1
-2
-3
1984 1986 1988 1990 1992 1994 1996 1998 2000 2002 2004 2006 2008 2010 2012 2014 2016 2018
fred.stlouisfed.org


Interest Rates in the United States
Percent of GDP
20.0
17.5
15.0
12.5
10.0
7.5
5.0
2.5
0
1955 1960 1965 1970 1975 1980 1985 1990 1995 2000 2005 2010 2015
fred.stlouisfed.org


Real Interest Rates in the United States [interest rates *minus* the rate of inflation]
%-% Chg. from Yr. Ago
10.0
7.5
5.0
2.5
0.0
-2.5
-5.0
-7.5
1960 1965 1970 1975 1980 1985 1990 1995 2000 2005 2010 2015
fred.stlouisfed.org


Growth of the Stock Market in the United States
Index
32,000
28,000
24,000
20,000
16,000
12,000
8,000
4,000
0
1975
1980
1985
1990
1995
2000
2005
2010
2015
fred.stlouisfed.org


Producer Price Index for All Commodities
Index 1982–100
220
200
180
160
140
120
100
80
60
40
20
1975
1980
1985
1990
1995
2000
2005
2010
2015
fred.stlouisfed.org


Ratio of United States Federal Debt to United States Gross Domestic Product
Percent of GDP
110
100
90
80
70
60
50
40
30
1970
1975
1980
1985
1990
1995
2000
2005
2010
2015
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intelligent and more aggressive and more numerous. Of course it's harder."

But thoughtful investors will continue to get their chance because, as Munger points out:

"Valuations will go up and down because they always have."

Looking back over the prior ten years, Charlie believes the Federal Reserve's actions to save the U.S. economy from collapse were appropriate. In addition to lowering interest rates to zero, the Fed took the radical step of purchasing more than $4 trillion worth of U.S. Government debt and mortgage-backed securities in an attempt to lower the interest rates paid on those securities.

"All this massive central bank interference, I think that was necessary to do. I admire the politicians who did it and the technocrats, including the Federal Reserve people. And I think it was absolutely required, and that the danger they were avoiding was worth some of the troubles they caused. But it was very peculiar. And it did have the accidental effect of bailing out the rich in order to help the poor. And nobody was doing that because they love the rich. They just didn't have any other tool in the kit, and they had to do something.

"It [the resultant increase in wealth inequality] wasn't malevolent. It was an accident. And it's not a permanent conspiracy against the poor. It was an accident that we had the huge recession caused partly by massive stupidity in finance and venality. And then when we ran out of tools [reducing interest rates] and had to do something really peculiar that we'd never done before [buying massive quantities of outstanding U.S. bonds], that was the wisest thing to do, given the amount of trouble we were in… We were facing *real* difficulties. And both parties and our technocrats got together for the last time, I think, and worked us out of it. It was a very admirable thing, and of that you can all be proud. I've been proud of nothing in politics since.

"I think we hit a peak of inequality because the authorities had no alternative but to print a lot of money. And, of course, that bailed out asset values [stock and housing prices stopped falling and then rose considerably]. But that was a fluke. And they can't really do more of it. They've played that game once, as much as they really can. And so I don't think people who were worried about inequality should worry too much about a lot more of it from a lot more interest rate lowering."

The Fed's actions could still have unhappy consequences.

"Nobody knows how much of this money printing we can do. And, of course, we have politicians in both parties who like to believe that it doesn't matter how much you do – that we can ignore the whole subject and just print money as is convenient. Well, that's the way the Roman Empire behaved, then it was ruined. And that's the way the Weimar Republic was ruined. And there is a point where it's dangerous. You know, and of course, my attitude when something is big and dangerous is to stay a long way away from it.

"I was surprised when central banks started printing money and buying massive amounts of private securities – they hadn't done that previously in my lifetime. At least not in a big way. And they did it *massively*. And it seems to have worked considerably. And that surprised me. And by the way, it surprised the whole economics profession. If you read the textbooks on economics, nobody was predicting that this would be the logical response."

Growing wealth inequality and unaffordable housing prices in many parts of the U.S. are just two side effects. Is this all we should fear from the Fed's efforts?

"No, of course not. You're never out of it until you're dead! [He laughs.]

"All human successes are successes *so far*. And this is a success *so far*, and we don't know for sure what the ultimate consequences will be. [Now] we're using methods that are so extreme that maybe we can't use a lot more of them. And we don't know the answer to that. If an economist told me he knew the answer to that, I wouldn't believe him. Either way. It wouldn't matter which way his opinion was. I just think we don't know."

The level of U.S. Federal debt continues to explode and recently surpassed the $22 trillion mark.

"We're in new territory. But that doesn't mean that it's crystal clear that we can't get by with what we've done. We just know we're in uncharted territory."

Though previously telling our own Darren Pollock that he does not expect the U.S. Government to be able to pay off its debts in the

future, how much Charlie worries about today's high debt level might surprise you.

"Well, I don't worry much, because in every era it is a cinch that a great nation will, in due time, be ruined. [He laughs.] Whether it's Rome, whether it's Britain in its heyday, they all pass. And so our turn is bound to come someday. But I don't like thinking about it too much. It's like my own death. Why should I enjoy thinking about it? But is it coming some day? Sure."

A meeting with Charlie Munger wouldn't be complete without his recipe for a happy life.

"You don't have a lot of envy, you don't have a lot of resentment, you don't overspend your income, you stay cheerful in spite of your troubles. You deal with reliable people and you do what you're supposed to do. And all these simple rules work so well to make your life better. And they're so trite… I'd say if you want to carry one message from Charlie Munger it's this: if it's trite it's right. All those old virtues work."

And, finally, Charlie's sense of humor was on display when he was asked why Warren is so much richer than he is.

"He got an earlier start. He probably was a little smarter, he worked harder. There are not a lot of reasons. [Long pause.] Why was Albert Einstein poorer than I am?"

CREDITS

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

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NOTES

[1]*Comedian Norm Macdonald said, "I'm thinking about investing in ledge space because so many people are looking for one from which to jump."*