Cheviot Value Management, LLC

Investment Values

Issue Number 131, July 2019

"Modest doubt is called the beacon of the wise." - William Shakespeare

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OUR INVESTMENT OUTLOOK

As of July 1st, estimates for second quarter U.S. GDP growth are down to 1.5%. Several leading indicators (statistics which may provide a glimpse into the near-term economic future) – from rail car traffic, industrial chemical demand, the ratio of durable goods inventories to sales, and many more – continue to point toward a potential slowdown in growth in various segments of the domestic economy. All the while, stock and bond markets ended the quarter on a high note and lower interest rates spurred housing demand.

The cause for such a divergence between various underlying economic fundamentals and market prices for stocks is tied to expectations for those who set interest rates in the U.S., the Federal Reserve (the "Fed"), to lower them. Financial markets celebrate lower interest rates for they delay the consequences of too much debt. Regular readers of our quarterly letter know that higher interest rates in many ways are poisonous to an overly-indebted economy. They cause borrowing costs to rise for corporations, municipalities, and homebuyers when those entities seek either to pay off old debt or to borrow new funds. A great number of American corporations, along with the U.S. Government, are in the unenviable position of being unable to pay off all outstanding debts through current and expected cash flows. Taking on new debt to pay off old debt is required (something Charlie Munger refers to as "Ponzi finance").

Bond manager Jeffrey Gundlach elaborates with vivid imagery, "The corporate bond market is really going to have trouble in the next recession. It's kind of like the Buffett idea when he says you know who's swimming naked when the tide goes out. Well, it's a nude beach out there." Low interest rates prevent many entities from being over-exposed.

The Fed's dramatic policy shift from raising rates to potentially lowering them during the past several months was precipitated by two factors: financial market turbulence (recall the near 20% decline in stock prices during a few weeks in the fourth quarter of 2018 and the freezing up of the junk bond market in November and December) and escalating trade tensions. As we discussed in a recent CBS Radio interview, the White House expects the Fed to support the economy and markets while the Trump Administration furthers on-again, off-again trade negotiations with China. As of the time we went to print, we continue to have the expectation that the U.S. and China will eventually agree to terms on trade, though it remains to be seen if curing technology and intellectual property theft can be enforced effectively.

While a broad trade agreement with China should help resolve some economic uneasiness, it appears that the U.S. economy is currently facing a greater than normal number of crosscurrents. "Remember," said investing legend Paul Tudor Jones last month, "we've had 75 years of expanding

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.

globalization and trade. And we've built the [global economic] machine around the belief that that was the way the world was going to be. Now all of a sudden it's stopped and we're reversing that. And so when you do something like that, when you break something like that, a lot of times the consequences won't be seen at first. They might be seen one year, two years, three years later. So that would make one think that it's possible we go into recession. It would make one think that interest rates in the U.S. go back toward the zero-bound level."

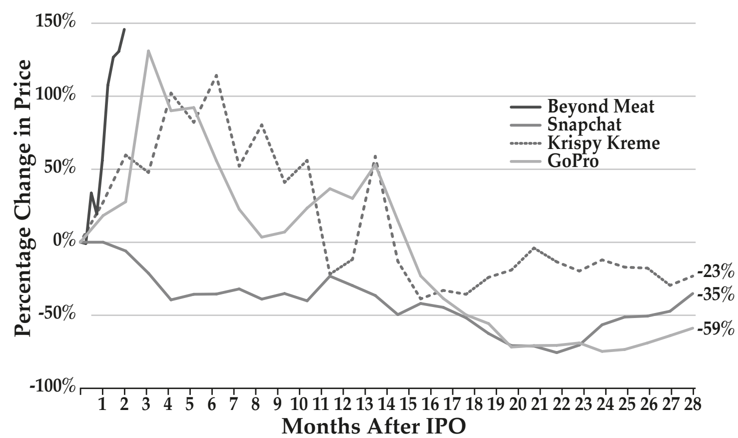
Many share prices are not egregiously expensive if interest rates are headed lower and remain low for a considerable length of time. That said, we believe investments should be managed with a strong understanding of the growing risks to the current economy. Between now and the 2020 Presidential election, we fully expect the Trump Administration to continue to push hard for lower interest rates and request crisis era monetary intervention to spur markets and the economy, as unusual as that is with stock prices and employment near all-time highs. And while economic risks might prove temporary, the history of the Fed's ability to ride to the rescue is mixed. Euripides once said, "The best and safest thing is to keep a balance in your life." At this time, we believe those words also describe accurately our investment mindset at Cheviot.

BEYOND A REASONABLE VALUATION: FOOD FOR THOUGHT

Beyond Meat was founded in Southern California in 2009 and its first product was a poultry-free "chicken" nugget sold via Whole Foods in 2013. Its most successful product so far, however, is the Beyond Burger, a meatless, plant-based burger possessing much of the taste and texture of a real beef patty. While working to expand its offering of meat-like foods, the company has lost approximately $25 million per year in each of the last three years. Yet rapid adoption of the company's flagship product is propelling sales dramatically higher and should push the company into the black by either 2020 or 2021.

Beyond's newly-issued shares made for one of the top ten fastest rising IPOs in U.S. history. Now, after the unexpected and "meaty"-oric rise of its IPO, investors must try to determine if Beyond's share price will return to Earth, suffering the fate of many prior

To Infinity for Beyond?



well-known consumer-oriented companies,[1] or if it will continue to surge higher. [See Notes on Page 7.]

Beyond Meat's products, made from pea protein, canola and coconut oils, and seasonings are compelling to consumers in three ways: 1. They are perceived to be healthier than market alternatives, 2. It is understood that Beyond Meat foods are produced using fewer resources and are better for the environment, and 3. Animal welfare proponents can support this beef-like product.

Whereas the health benefits of the Beyond Burger center around the lack of cholesterol in the faux-meat product, the environmental benefits of alternative meat appear wider-reaching. Beyond Meat states that it uses 99% less water, 93% less land, and 46% less energy to produce its burger compared to a standard quarter-pound American-made beef burger. Cattle farming produces anywhere from 9% to 15% of the world's greenhouse gas emissions. (119 million tons of methane was emitted from cows in 2011.) Methane is 23 times more potent a greenhouse gas than carbon dioxide. Roughly one quarter of the world's land is used to support livestock pasture; deforestation in places like the Amazon basin is increasingly due to cattle ranching. Growing worldwide taste for and consumption of animal protein is expected to continue outpacing population growth, which is estimated to reach 10 billion in the next thirty years. New alternative protein sources could help combat shrinking availability of natural resources relative to the size of the global population.

With these factors supporting the alternative meat industry, Beyond's chief accomplishment was not to produce another veggie burger made of any combination of soy, black beans, wheat, etc. – the likes of which have been in the market for many years. Beyond succeeded in producing an innovative, meat-free burger that even meat-eaters might crave. Beyond Meat targeted and succeeded on this middle ground of the market between uninspiring veggie burgers and those made from real beef.

Beyond and its upstart counterpart, Impossible Foods, maker of the Impossible Burger (which is nearly identical in look, taste and texture to the Beyond Burger), are satisfying the demand of consumers craving a meatless burger. The rapidly growing acceptance in the marketplace for faux-meat is bringing great growth to this nascent market niche. It is expected that Beyond will gain market share from the 9% stake it currently holds in the meatless burger space. Furthermore, Beyond possesses first-mover advantage in U.S. grocery stores, which provides a halo effect around its brand in the minds of consumers. (Importantly, first-mover advantage is sometimes overstated because it can be eroded. Apple, for all its staggering success, rarely is first to market with a product – the Palm Pilot arrived in 1997, and Microsoft created far more functional tablets a few years later – Apple's iPad reached the market in 2010. The first cola beverage was created in 1881. Coca-Cola did not appear for another five years.)

More than just vegetarians are buying Beyond Burgers in grocery stores. Beyond states that 93% of customers who purchased Beyond Burgers at Kroger locations also purchased animal protein. This indicates that consumers may be replacing animal protein for the occasional plant-based patty and buyers are not simply vegetarians finding different plant sources of protein.

Beyond is established in several quick service restaurants ("QSRs"), selling burgers through 1,100 Carl's Jr's locations in the U.S. and producing meatless meat for "Beyond Tacos" at 580 Del Taco establishments. Tim Horton's of Canada is now selling a sausage patty from Beyond. Burger King's huge success with the Impossible Whopper is putting pressure on McDonald's to add a plant-based burger here in the U.S. Currently, McDonald's is successfully selling plant-sourced patties made by Nestle (with its similarly-named "Incredible Burger") in 1,500 McDonald's locations in Germany. There is speculation that McDonald's may partner with Beyond to supply meatless burgers to its stores in the U.S. (Interestingly, former McDonald's CEO, Don Thompson, is a director of Beyond Meat.)

QSRs that have incorporated non-meat burgers in recent months have seen a considerable increase in traffic to those restaurants. For established fast-food companies, plant-based patties are the holy grail: their sales appear not to be cannibalizing existing purchases at their locations, *i.e.*, customers are not merely switching from one menu item to another. Instead, customers are making more trips and possibly *entirely new* customers are visiting fast food chains to try these burgers. At test locations with the Impossible Whopper, traffic to Burger King increased by 18.5% relative to its locations that do not serve the plant-based patty. The pressure is on McDonald's to act soon.

Adding to the aura of Beyond is the virtuous cycle of reflexivity enveloping the company: Beyond's hugely successful IPO may be helping to grow awareness and demand for the Beyond products. The higher Beyond shares climb, the greater

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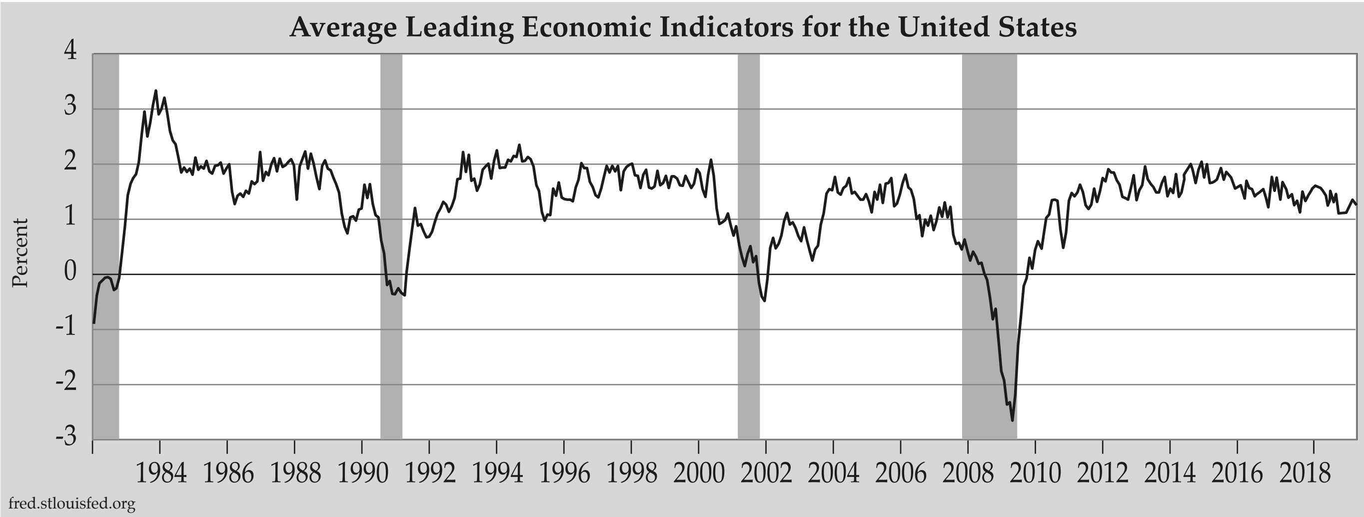
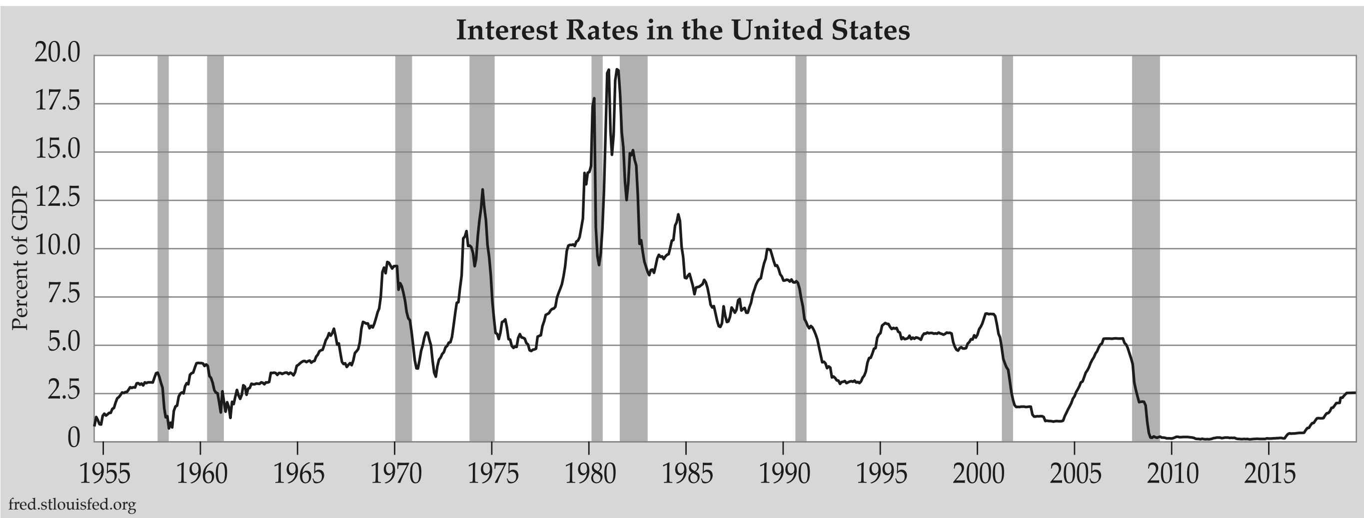
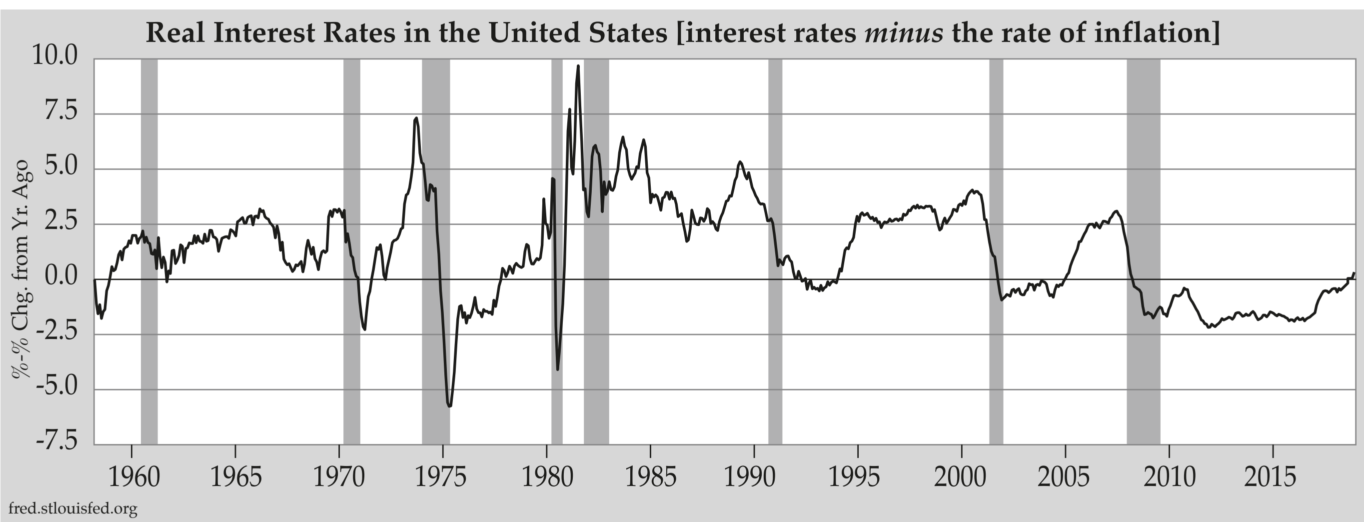
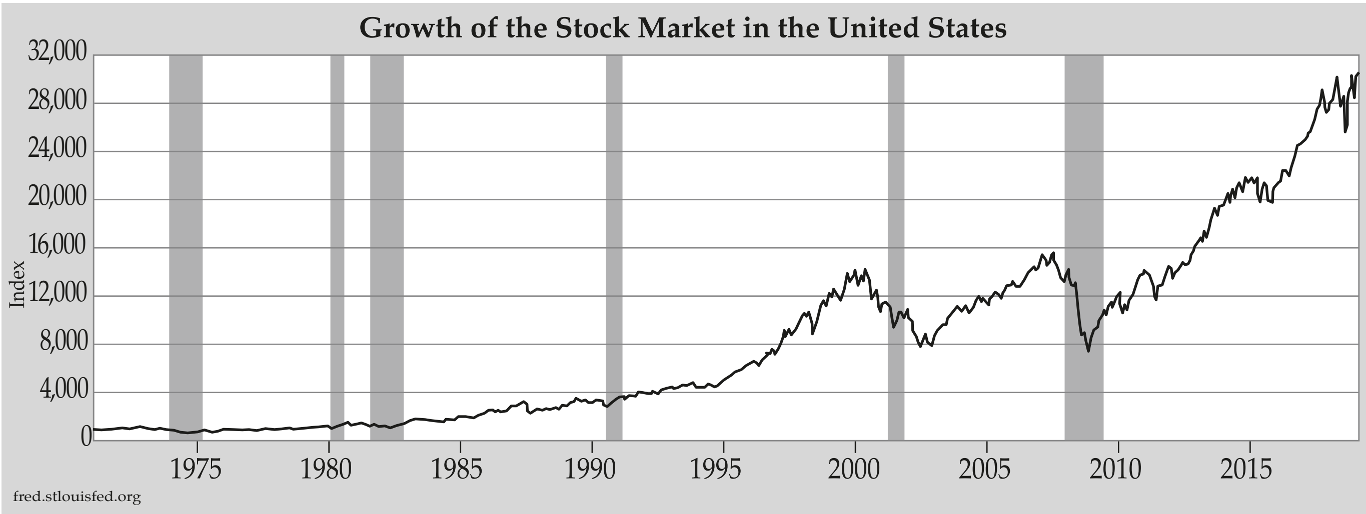
ON THE NEXT TWO PAGES…

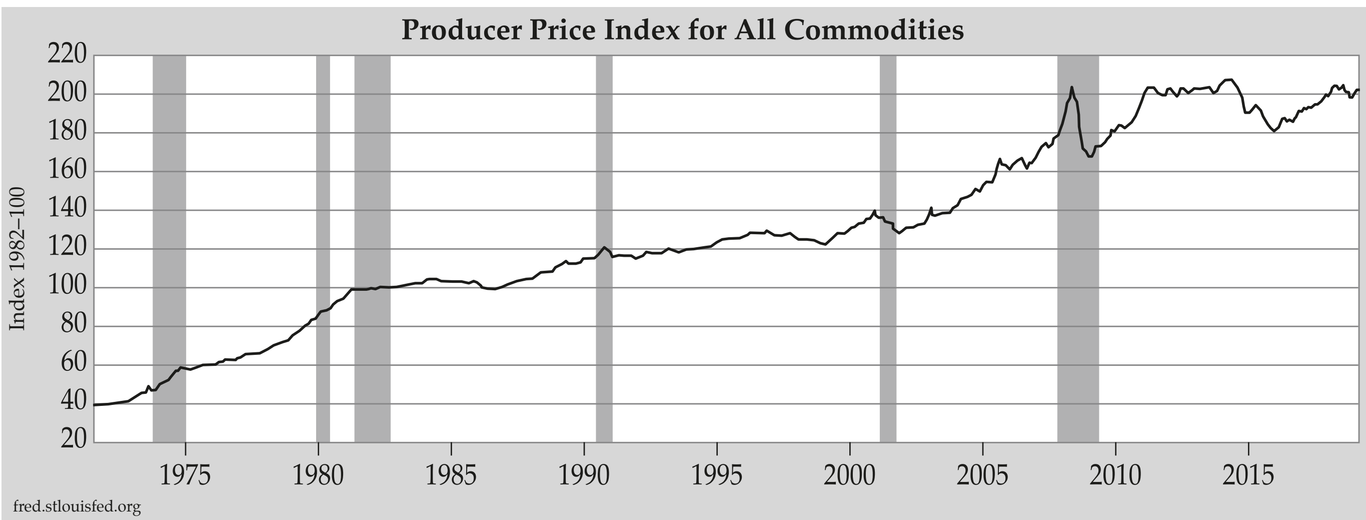
…We share a small sample of graphs that we believe paint a broad picture of U.S. economic activity and sentiment. Graph 1, Average Leading Economic Indicators, compiles ten important economic data points, including those related to manufacturing, employment, and consumer sentiment. Graph 2, Interest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

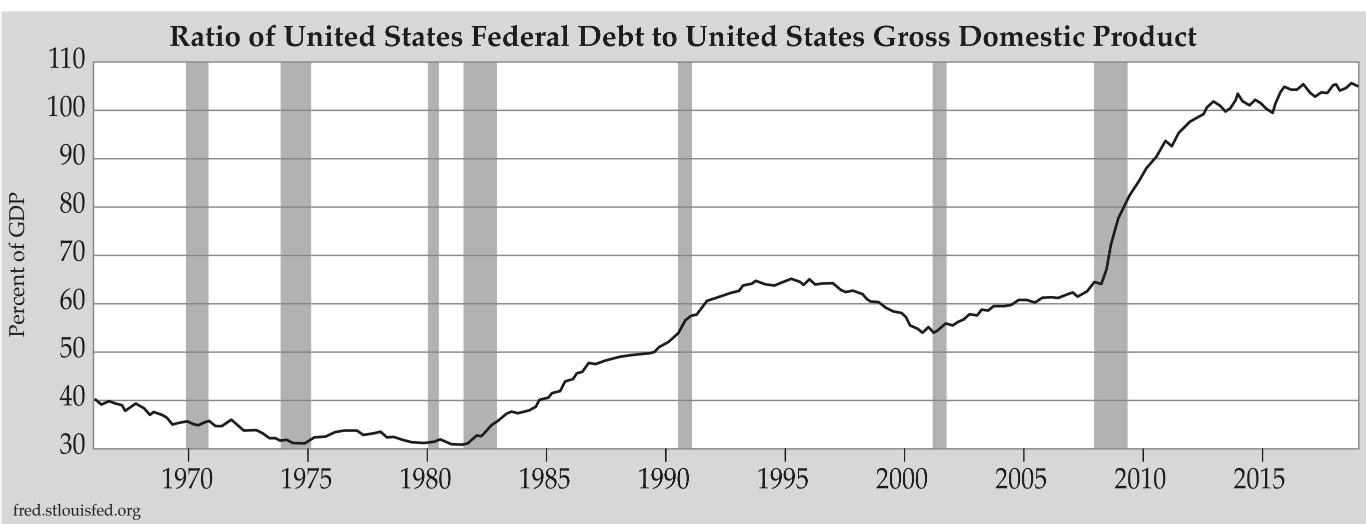

Average Leading Economic Indicators for the United States
Percent
4
3
2
1
0
-1
-2
-3
1984 1986 1988 1990 1992 1994 1996 1998 2000 2002 2004 2006 2008 2010 2012 2014 2016 2018
fred.stlouisfed.org


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
32,000
28,000
24,000
20,000
16,000
12,000
8,000
4,000
0
Index
1975
1980
1985
1990
1995
2000
2005
2010
2015
fred.stlouisfed.org


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


Ratio of United States Federal Debt to United States Gross Domestic Product
110
100
90
80
70
60
50
40
30
Percent of GDP
1970
1975
1980
1985
1990
1995
2000
2005
2010
2015
fred.stlouisfed.org

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the favorable publicity received by the company and the product, and the Beyond brand generates more goodwill – and potential consumers.

Smartly, Beyond is not resting on the laurels of the considerable success of its Beyond Burger. The company is pouring money into research and development to bring an assortment of products to market in the next few years, including Beyond Sausage Patties, Beyond Bacon, and Beyond Poultry Nuggets. (We at Cheviot already thought that most chicken nuggets were "beyond chicken.")

Working against the company is the fact that the size of its market is somewhat restricted by the high price point of Beyond's faux meats. Its burgers are one-and-a-half to three times pricier than competitor products (both veggie and real beef). The company hopes to lower its prices, but this could squeeze future profit margins.

Competition is gearing up to battle Beyond's position as the sole major purveyor of alternative meats at U.S. grocery stores. Later this year the Impossible Burger will reach store shelves. Nestle's Awesome Burger (the name for its U.S. product) and an as-yet-unnamed burger from Tyson Foods also will be available. In Brazil, the world's largest meat producer, JBS, has unveiled a plant-based burger. Private label faux meat will not be far behind.

Whereas Tesla propelled the electric vehicle industry ahead by creating a product that consumers truly desired, competition in the auto industry could not come to market with similar products as quickly as competitors can emulate plant-based burgers. It takes far longer to design and produce electric vehicles than to create meat-free meat. As with Tesla, Beyond is leading the charge – for now.

In addition to competition from Impossible Burger and other meatless patties, longer-term threats to Beyond's business are expected to come from lab-grown meats. Using merely the cells from livestock, companies are able to produce meat without any farming at all. In 2013, the cost to produce one ounce of lab-meat was $1.2 million. This year that price has fallen to below $50. And this threat is not just some twinkle in the eye of a futurist; the FDA is currently producing a framework to regulate what the lab growers refer to as "clean meat." While this product may not be satisfactory for vegetarians, recall that a large portion of Beyond's market are meat-eaters who in coming years might prefer a product that tastes even more like the real thing.

Plant-based egg producer JUST Inc. has produced a line of hatched-in-the-lab chicken nuggets that will soon begin selling in Asian markets. JUST Inc. is also working on culturing Wagyu beef cells from some of the most sought-after cows in Japan and producing various alternative-beef products for sale in the U.S. within a year or two. The giant food processor Cargill has invested in Aleph Farms' attempt to bring lab meat to market. Another company, New Age Meats, sourced its lab-made pork sausage from the cells of one pig it refers to as its Chief Sausage Officer.

Further out on the competitive landscape, there are companies like food-tech concern Gingko Bioworks. One of its subsidiaries, Motif Ingredients, is avoiding animal agriculture to "engineer dozens of proteins derived from dairy, egg and meat without compromising the functionality, taste and nutrition of animal-based ingredients." Jeff Bezos, Michael Bloomberg, Richard Branson and Bill Gates are among the company's financial backers. Much money is being spent by numerous food-tech businesses in the far-reaching quest for new sources of protein. To get an understanding of just how far these companies have ventured, one player in the field, Sustainable Bioproducts, sources the ingredients for its alternative-meat proteins from deep inside the volcanic hot springs of Yellowstone National Park. The company states that its product is a "super-protein" that will be brewed in an environmentally friendly process similar to how beer is produced. It is backed by, among others, the venture arms of giant food producers Danone and Archer Daniels Midland.

So, is Beyond an investable company or is it operating in a rapidly changing and soon-to-be fiercely competitive industry with increasing choices for consumers? Many investors would read through the above bull and bear arguments and conclude that it is too difficult to understand Beyond's future for it to be considered an investment and not a speculation. And it is perfectly acceptable for an investor to determine that a company's future is simply too difficult to forecast. After all, Beyond's success is not fortified with a patented product, just the goodwill from being an early and popular entrant in the marketplace. And, while investors may predict accurately how an entire industry will evolve over time, picking which company will succeed in that industry can be close to impossible.

Should an investor consider all of the aforementioned and believe it makes for an investable opportunity, then the next question must be: at what price? A great story is only part of the underpinning of a successful investment. The price paid for such an investment must also be compelling.

At the recent share price, the company will need to grow its revenues at an average annual rate well above 25% for the next *decade* – and then continue to grow them at a healthy clip after that – to produce the level of earnings that would justify today's enthusiasm for Beyond shares. We expect Beyond to enjoy tremendous growth during the next few years, but competition will be fierce, too.

While Beyond has the potential to be a highly profitable leader in this ever-changing industry, stock market history is full of examples of growing companies that disappointed their investors who overpaid for their shares. At a stock price anywhere near these levels, we will let the speculators play with the company's shares. True investors are better served holding a portfolio of companies with more certain long-term competitive advantages that are also more intelligently priced. Those investors can then enjoy a Beyond Burger purchased with dividends from their more stable investments.

CREDITS

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

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NOTES

[1]Former favorites include the shares of Krispy Kreme Donuts which debuted in 2000 and quickly tripled to $100. It was acquired 16 years later for $21. GoPro shares hit the market in 2014, rapidly quadrupling to $100 but now residing at $5. Snapchat parent, Snap, rose 44% to $25 on its opening day and within two years was lower by 80% and today resides at $14. National Beverage Corp., maker of LaCroix flavored sparkling waters, rode LaCroix's popularity from a share price in the $20s up to the $120s and now back into the $40s after numerous companies came to market with new flavored sparkling waters.

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.