Cheviot Value Management, LLC

Investment Values

Issue Number 132, October 2019

"The study of history, while it does not endow with prophecy, may indicate lines of probability." - John Steinbeck

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OUR INVESTMENT OUTLOOK

As the U.S.-China trade war raged on, markets domestically and abroad gyrated and made little progress during the third quarter. Slowing global growth caused central bankers to further ease monetary policy (Europe's central bank lowered interest rates deeper below zero) in an attempt to bolster economic activity and financial markets. The U.S. Federal Reserve (the "Fed") lowered rates in July and September and another quarter-point rate cut is possible before year-end.

Low interest rates motivated numerous companies to borrow funds – even if more capital was not needed. Berkshire Hathaway, already boasting a war chest of approximately $125 billion in cash, issued $4 billion worth of bonds in Japan. The 10-year Berkshire I.O.U. promises to pay its Japanese lenders the paltry rate of 0.44% per annum. With such a low hurdle rate of investment for Berkshire, this move underscores the notion that it is better to borrow when you *want* to rather than when you *need* to.

As of when we went to print, the threat of impeachment looms over the Trump Administration. Having weathered prior investigations during President Trump's term, the markets are looking past impeachment fears with considerable calm. For better (as U.S. citizens) or worse (as financial market historians), there are very few historical parallels from which to draw. From the onset of President Nixon's impeachment to the date when he resigned, the U.S. stock market declined by 13%. During President Clinton's 14-month impeachment, stock prices rose by 28%. This sample size of two is insignificant and how markets will respond to a potential impeachment of President Trump in coming months is unknowable. The direction of the economy and actions taken by the Fed regarding interest rates and by the Trump Administration regarding the trade war are likely to be far more meaningful drivers of market behavior.

Should the global economy continue to drift lower and if the trade war goes unresolved in the near term, market prices could decline, providing us with worthwhile buying opportunities. This potentiality is why our portfolios are well-balanced and prepared for a multitude of economic outcomes. We prefer not to be greedy in this environment but rather to be prepared to make long-term commitments to high quality companies – and only when offered to us at intelligent prices.

FALLING OFF THE PRESIDENTIAL CYCLE?

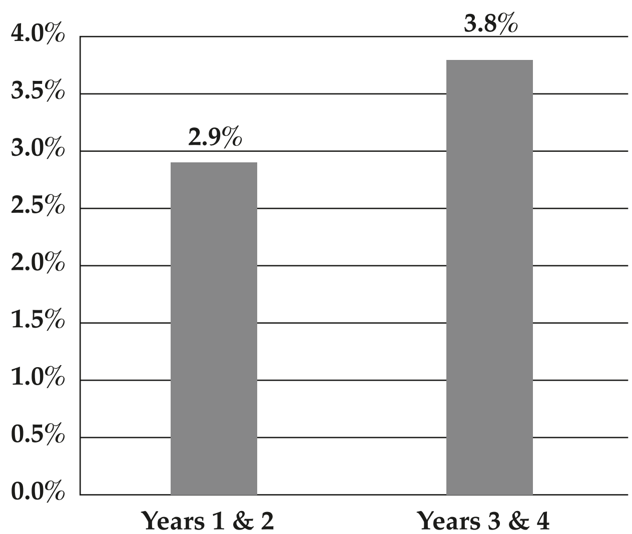
Adam Smith's 1776 tome on economics, The Wealth of Nations, contains many enduring pillars of economic thought. Notably among them is Smith's notion that a capitalist economy is predicated on individual financial self-interest, which is not only a phenomenon to be expected, but an influential economic force. The metaphor Smith uses to describe this was that of an "invisible hand" guiding the behavior of each individual. When viewing economic history and the business cycle in the U.S.,

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.

a similar politically-motivated "invisible hand" emerges which is important to understand and consider as part of a larger framework for making investment decisions.

There is a certain rhythm to the U.S. economy's ebbs and flows dating back nearly 100 years. Since 1930, growth in U.S. GDP averages less than 3% per year during the first two years of a president's term. In a president's third and fourth years in office, the average annual rate of growth jumps to nearly 4%. The pattern of strong growth entering an election giving way to weaker growth in the first couple years of one's term – and repeating itself over time – is more than mere coincidence.

Average Growth in U.S. GDP for First 2 Years vs. Last 2 Years of a President's Term, Since 1930



In the first months and quarters after an election, presidents often enact – or at least attempt to – a great many new policies that differ from those of the prior administration. Many of these changes take time to be implemented, others are simply proposed, but, in this period of time, corporate leaders are left waiting for greater clarity regarding the impact on their businesses made by these changes. Such uncertainty regarding new laws causes executives to postpone decisions about expansions and other business plans, resulting in a slowdown in economic growth.

By years three and four, with the fog of uncertainty clearing, presidents focus on further improving the economy. Softness in years one and two make economic stimulus packages easier to pass and, with some help from the Fed, the economy regains its footing in years three and four. Historical evidence indicates presidents capitalize on this pattern.

Says Jeremy Grantham, investor, market historian and student of the presidential cycle: "What moves the dial on Election Day, is the shift in employment six months up to the election. A year before, it doesn't matter. It is all forgotten. Six months before the election, you've got to have a strong looking labor movement with strong labor results. And to do that, you've got to stimulate the economy a year or 18 months ahead of that to get the lag effect. And that's what presidents do."

In notable contrast to previous presidents, the Trump Administration has thus far used a different playbook. It enacted pro-business legislation immediately upon entering office. It then lowered corporate and personal income tax rates for the majority of Americans. This fiscal policy was highly stimulative to the U.S. economy, boosting growth in 2018, the second year of the president's term. GDP growth in the U.S. climbed for six consecutive quarters since the Trump Administration took office, finally leveling off in the third quarter of 2018.

This growing U.S. economy allowed the Fed finally to lift interest rates from the ultra-low, crisis-era levels where rates were held for nearly a decade. That, coupled with the beginning of President Trump's trade war with China, caused global economic activity to slow. In the U.S., GDP growth continues to trend lower since its mid-2018 high. In the first half of 2019, U.S. economic growth measured 2.46% – the lowest of the three years of this presidential term, stair-stepping down from 2.80% and 2.52% in years one and two, respectively. (This also compares unfavorably with the historical year three presidential average of 4.11% but does not factor for global economic conditions.)

Manufacturing job growth in the U.S. is also well below the gains achieved in the first two years of the Trump Administration. In this year's first half, manufacturing jobs have been lost in nearly half of the country, including swing states Wisconsin and Pennsylvania. Industrial production in the U.S. has contracted for two consecutive quarters, a decline not seen since 2016 – just when the teetering manufacturing economy helped sway many voters to consider the allure of then-candidate Trump's economic promises.

Unlike President George H.W. Bush's time in office when he raised taxes and the Fed hiked interest rates near the end of his term, leading to an economic slowdown which harmed his chances of re-election (recall James Carville's reminder to candidate Bill Clinton during the 1992 campaign: "It's the economy, stupid"), President Trump continues to apply tremendous pressure on the Fed to stimulate the economy. He asks the Fed not just to lower interest rates to zero but to administer quantitative easing, a stimulative measure reserved for the worst of economic crises. Jay Powell, the Fed Chairman, has "no guts, no sense, no vision," says Trump, also referring to him as an "enemy" of the U.S.

The effects of raising or lowering interest rates often work with a considerable lag, so – with the Fed lowering rates twice in the past few months and more cuts potentially on the way – there remains time for growth in the economy to accelerate before the 2020 election. Furthermore, the Trump Administration can at any time soften its stance and consummate a trade deal with China, as almost any deal will remove the uncertainty hanging over businesses today, probably unleashing business activity and potentially elevating stock prices. We expect Trump to make a deal well in advance of the 2020 election but, of course, China must also agree to any such deal. And China certainly understands that tough and ongoing negotiations with the U.S. could prolong economic softness in the U.S. – just when Trump most desires a strong economy.

In general, the political machinations that affect the economy are difficult to predict. And while there is often an underlying desire on the part of an incumbent president to spur economic growth leading up to an election, there remain numerous other variables whose understanding is crucial to successful long-term investing. We at Cheviot analyze a mosaic of economic and financial data to help us navigate markets. It is important that your hard-earned savings be invested prudently in companies that can weather political and economic cycles.

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 retirement and estate planning, charitable giving, insurance advice, and more. Because we are dedicated to providing personalized financial advice, the below recommendations are broad overviews whose finer points we would be glad to further discuss with you. 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,

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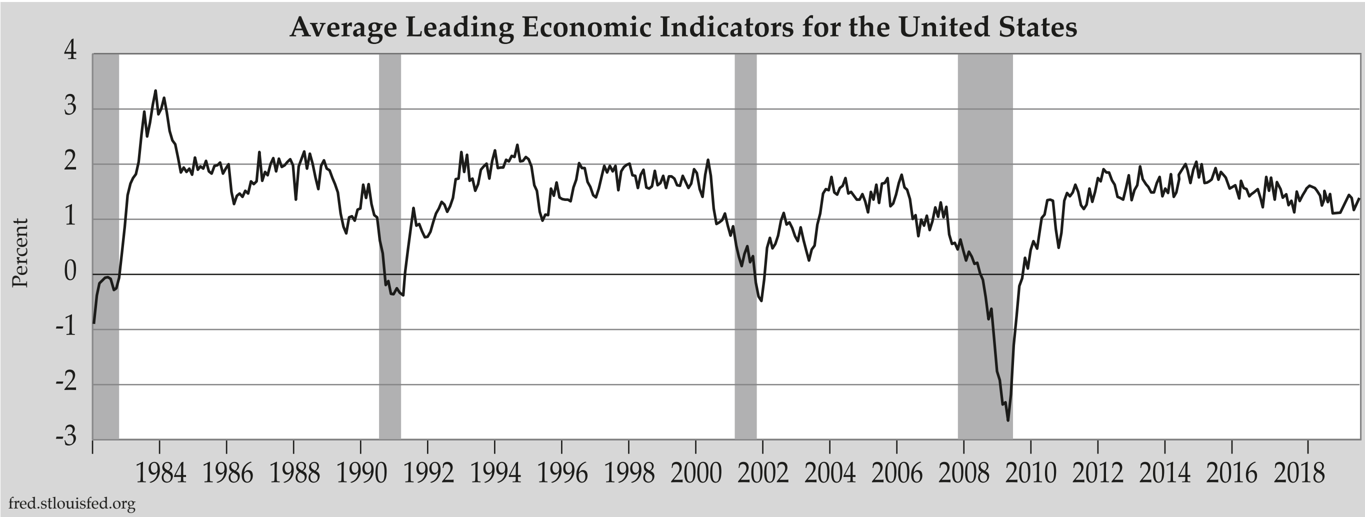
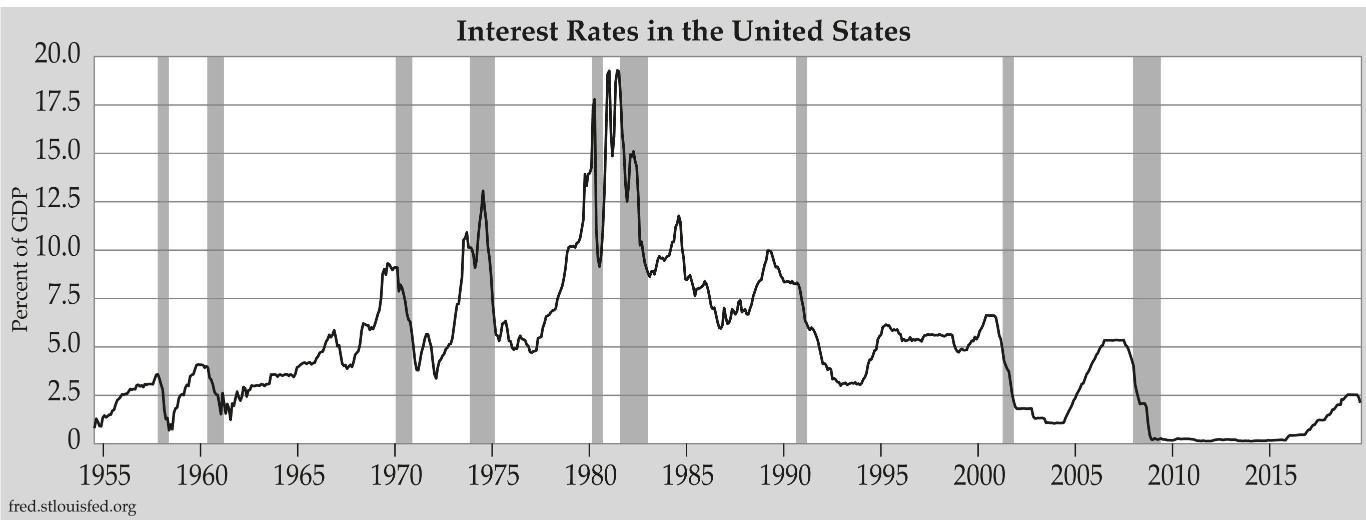
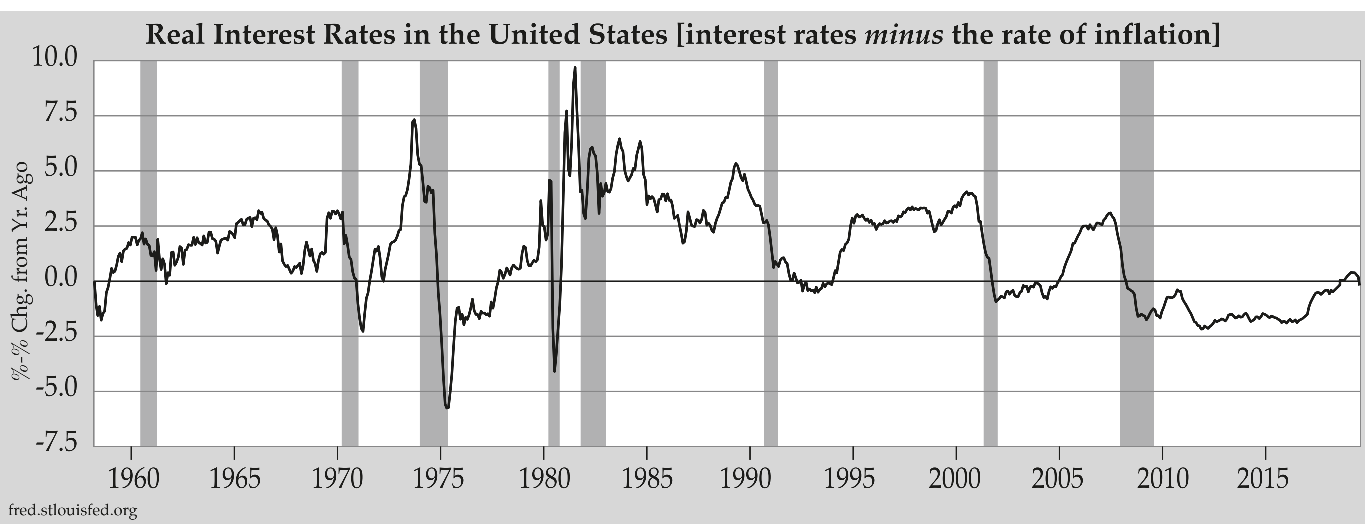
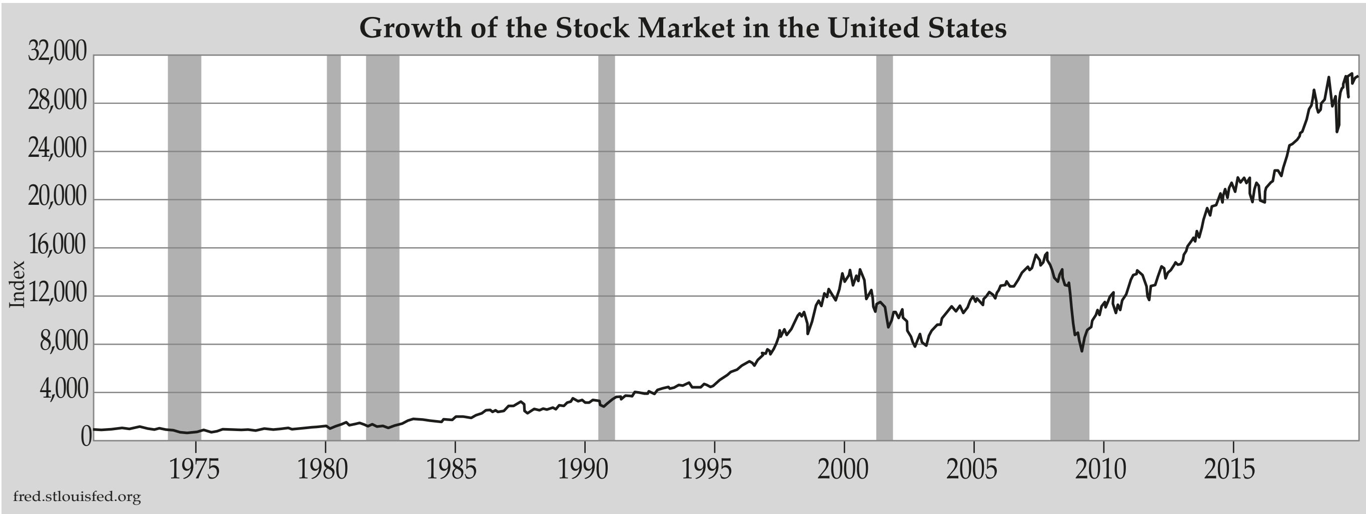
ON THE NEXT TWO PAGES…

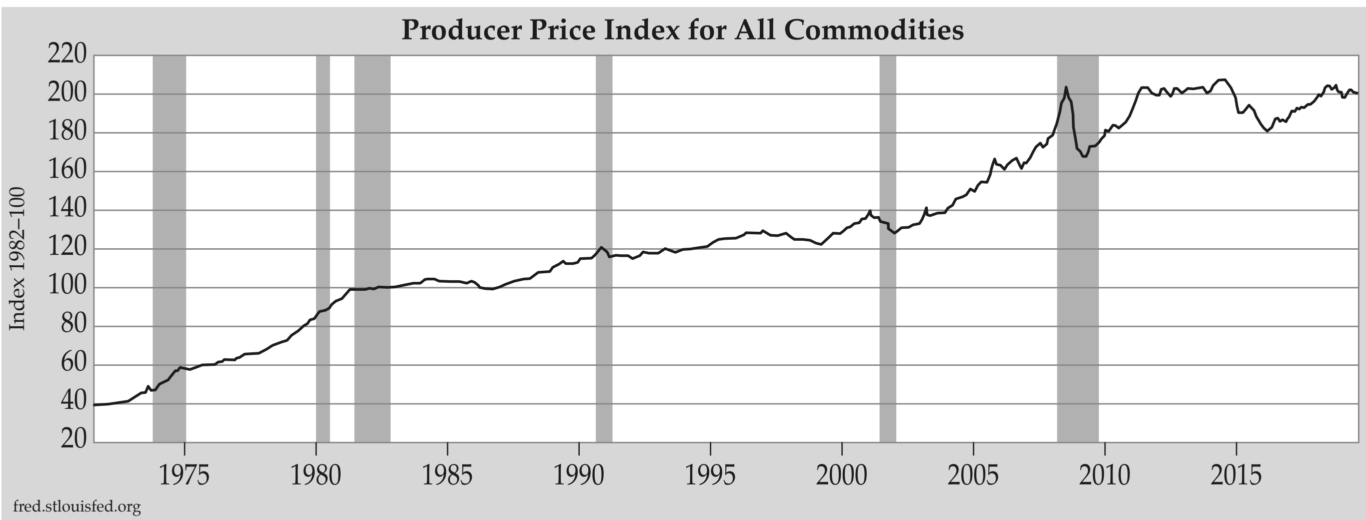
…We share a small sample of graphs that we believe paint a broad picture of U.S. economic activity and sentiment. Graph 1, Average Leading Economic Indicators, compiles ten important economic data points, including those related to manufacturing, employment, and consumer sentiment. Graph 2, Interest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

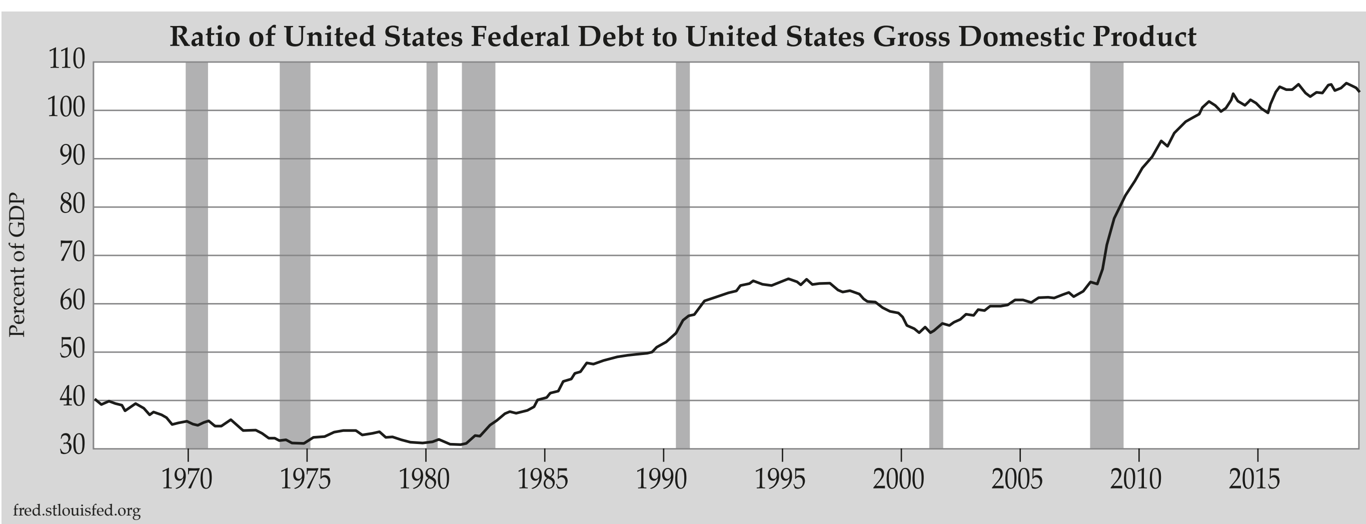

Average Leading Economic Indicators for the United States
Percent
4
3
2
1
0
-1
-2
-3
1984 1986 1988 1990 1992 1994 1996 1998 2000 2002 2004 2006 2008 2010 2012 2014 2016 2018
fred.stlouisfed.org


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 same quantity of shares that were donated could also then 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)

The 2019 annual gift tax exclusion is $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

The gift/estate exemption base increased in 2019 to $11,400,000 per individual. (Couples 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/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.

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 Heath Savings Accounts, so if you are able to delay spending the funds, you can secure many years of tax-free compound 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 2019.

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

After age 70½, one must take minimum required distributions from traditional IRAs (including rollover and SEP-IRAs) and 401(k) accounts (in most cases). Failure to take the required minimum distribution by December 31st 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.

Refinance Variable Rate Debt

For a number of reasons discussed over the years in this letter, interest rates have once again touched historic lows. Because of this, now is the time to refinance or pay off loans that have a variable rate in danger of rising. A fixed rate may be slightly higher than current variable rates, but in the long run, fixed rates today could be substantially lower than variable rates in the future, creating considerable savings in borrowed interest. A fixed rate may be slightly higher than current variable rates, but in the long run, fixed rates today could be substantially lower than variable rates in the future, creating considerable savings in borrowed interest.

Reduce Taxable Income by Making Retirement Contributions

One of the biggest changes made last year to the tax code was the rolling back of long-standing deduction rules, with the standard deduction being nearly doubled to $12,200 for individuals and $24,400 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. State and local tax deductions are now capped at $10,000, and only the interest attributable to mortgages of $750,000 or less (originated in 2018 or later) is deductible. Individuals that foresee large state and local tax bills or have (new) mortgage balances greater than $750,000 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.)

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, 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").

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.

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.

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