

# INVESTMENT VALUES

Issue Number 121, January 2017

*“Invert, always invert: Turn a situation or problem upside down. Look at it backward. What happens if all our plans go wrong? Where don’t we want to go, and how do you get there? Instead of looking for success, make a list of how to fail instead – through sloth, envy, resentment, self-pity, entitlement, all the mental habits of self-defeat. Avoid these qualities and you will succeed. Tell me where I’m going to die, that is, so I don’t go there.” - Charlie Munger*

CONTENTS	Page
<i>Our Investment Outlook</i> .....	1
<i>Darren Sits Down with Charlie Munger</i> .....	2
<i>Composite Portfolio Update</i> .....	6
<i>Notes</i> .....	7
<i>Credits &amp; Composite Disclosure</i> .....	7

## OUR INVESTMENT OUTLOOK

U.S. stocks ended the year in an upswing, rising 5% from when the market closed on Election Day until the last day of 2016. As of the time we went to print in early January, the Dow Jones Industrial Average (“the Dow”) continues to flirt with the much-ballyhooed level of 20,000. We humans love when our numbers are round.

Propelling the stock market higher since the election is the belief that a decidedly pro-business political environment – which sets forth public policy that includes a combination of tax cuts, increased government spending, and deregulation – will spur a large increase in U.S. employment and economic growth.

In 1789, Benjamin Franklin wrote, “In this world, nothing can be said to be certain, except death and taxes.” To see that quote through the lens of today’s financial markets would cause us to change a few words, perhaps: “In this world, nothing can be said to be certain, except death and tax *cuts*. *And* increased fiscal spending. *And* sweeping regula-

tion.” Market participants believe that these will be the economic pillars of the near-term future and, as such, their “animal spirits” are rising. (This is the phrase originally coined by economist John Maynard Keynes and later examined further by behavioral economist Robert Shiller. It is the name given to the optimistic emotions that fuel financial decisions.)

When animal spirits are ignited, already-high valuations for all manner of investment assets can become even further detached from their underlying fundamentals. Time will tell if this round of animal spirits is warranted. Two important points in financial history may provide food for thought.

President Dwight Eisenhower enacted the construction of the U.S. interstate highway system with the signing of the U.S. Highway Act in June of 1956. Spending on the project was \$25 billion. On an inflation-adjusted basis, this was more than 15% larger than the spending on all of the Public Works and Works Projects programs administered to help resuscitate the U.S. economy during the Great Depression of the 1930s. As President Donald Trump might say about the U.S. Highway Act, “It was a big deal.”

When Eisenhower signed the Act on June 29, 1956, the U.S. unemployment rate stood at 4.3%. It remained there and averaged 4.3% for the entirety of 1957. It then rose to an average of 6.8% during 1958, peaking at 7.5% in the middle of that year. It was not until an entire decade later, and under completely

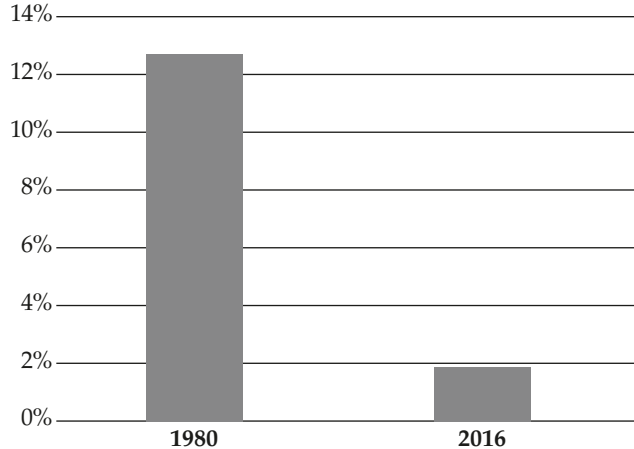
*Cheviot is in its 33<sup>rd</sup> year of serving investment clients throughout the U.S. We deliver personalized investment and financial management expertise to simplify our clients’ complex financial lives. Our firm’s investment objectives are to protect and increase our clients’ wealth through safety-first 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.*

different economic circumstances, before the U.S. unemployment rate worked itself below the level where it stood when Ike signed the Highway Act in mid-1956. If history is any guide, at 4.6% as of the 4th quarter 2016, it may be difficult to push today's unemployment rate much lower.

When Ronald Reagan was elected president in November of 1980, the unemployment rate stood at 7.5% and was steadily moving higher. It peaked at 10.8% two years later. Stock prices in late 1980 were low: the price to earnings ratio ("P/E") for the S&P 500 was 9. A buyer of U.S. Government bonds due 10 years hence locked in a rate of 12.7% (*per year!*). Prices for investable assets were cheap. Animal spirits were asleep.

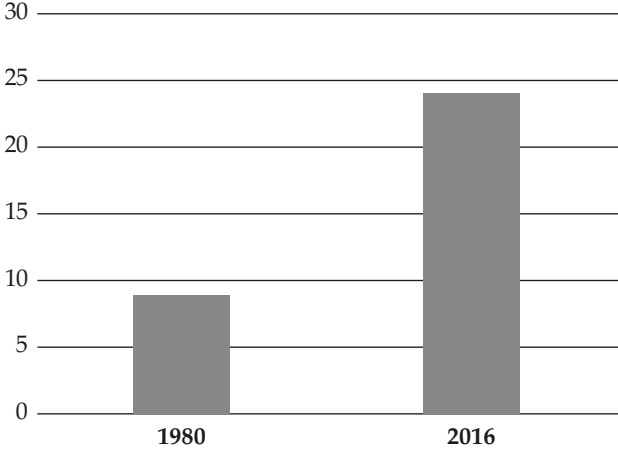
**The 10-Year U.S. Government Bond Yield**  
*More Room to Decline and Stimulate Then vs. Now*



Within three weeks of the 1980 election, stock prices soared by 10% on the hopes that Reagan's pro-business policies would vanquish the economic malaise that was spilling over from the 1970s. The parallel to today is quite strong. But the party then was short-lived. As of February 1981, a decline had wiped out that spurt higher and stock prices then continued their decline into the summer of 1982. From the Reagan election-rally peak in November 1980 through August 1982, share prices fell by 28%. The P/E ratio was then a paltry 8 – mouth-wateringly low for buyers of stocks. Bond yields were at what proved to be a generationally high level. From those low expectations and extremely cheap valuations– they were in the bottom decile relative to history – there was tremendous room for invest-

ments of all kinds to perform extraordinarily well prospectively. As a result of dormant animal spirits, low prices can be a launching pad for future gains.

**Stock Market Valuation: the P/E Ratio**  
*Less Room to Rise Now vs. Then*



Market valuations today are in the top decile of their historical range. Interest rates, though they have jumped since the election, remain near generational lows. The 10-year U.S. Government bond that paid 15% annual interest to buyers at its peak rate in 1982, pays 2% to buyers today. When interest rates decline, borrowing becomes cheaper. This facilitates business activity and may stimulate economic growth. At 15%, interest rates had a long way to fall and cultivate improved economic growth in the early 1980s. With interest rates as low as they are today, the opposite may be true.

If market valuations today were where they were at the time of Reagan's first term in office, we would be buying shares with great enthusiasm. Though the magnitude and duration of animal spirits are unpredictable, given the loftiness of where bond, real estate, and stock valuations are, we remain more balanced and cautious. We are hopeful for greater economic growth in the U.S. But we will invest your funds according to hard data, not emotion, and we will not ignore history with your hard-earned money.

**DARREN SITS DOWN**  
**WITH CHARLIE MUNGER**

Charlie Munger's partner in running Berkshire Hathaway for the past five decades, Warren Buffett,

compares Munger to Benjamin Franklin and says he has the quickest and sharpest mind of anyone he knows. Bill Gates, a Berkshire Hathaway board member and longtime friend of Buffett and Munger, says Charlie is “truly the broadest thinker I have ever encountered.”

It should be no surprise that Munger is a learning machine, “a book with two legs sticking out,” as his children and grandchildren see him. “I met the towering intellectuals in books,” he says, and he did so at an early age. “I can’t remember when I first read Ben Franklin. I had Thomas Jefferson over my bed at seven or eight. My family was into all that stuff, getting ahead through discipline, knowledge, and self-control.”

Given Charlie’s own towering intellect (and experience, among other things, as a master investor, philosopher, and philanthropist) we were excited when our Darren Pollock had the good fortune to spend an evening with him last quarter. Charlie was at his best – generous with his knowledge and quick with his wit. What follows is a selection of topics they discussed, with quotes from the evening (as best they were remembered), interwoven with more of our favorite Munger wisdom that he has offered over the years. Consider it an incomplete tribute to an intellectual hero of ours as he turns 93 years young.

### ***On Holding Cash***

At the outset of their meeting, Darren and Charlie talked immediately about portfolio management and Darren expressed Cheviot’s desire to hold a considerable amount of money market funds for our clients given the historically elevated levels of not just the prices for stocks but also bonds and real estate. Charlie’s eyes seemed to twinkle:

“That’s right, you *should* hold a lot of cash! People don’t understand the wisdom of that let alone the value of it. Does anyone complain about that? Actually, I know they must. I hope you tell them to find something else to worry about!” And he laughed. It reminded us of when he previously

said, “There are worse situations than drowning in cash and sitting, sitting, sitting... It takes character to sit there with all that cash and do nothing. I didn’t get to where I am by going after mediocre opportunities.”

“It’s waiting that helps you as an investor, and a lot of people just can’t stand to wait. If you didn’t get the deferred-gratification gene [at birth], you’ve got to work very hard to overcome that.” It takes considerable time and much study to determine which companies to buy. And successful investing requires discipline to wait for those companies to be priced right for purchase. To Munger, the investor needs “this crazy combination of gumption and patience, and then being ready to pounce when the opportunity presents itself, because in this world opportunities just don’t last very long.”

### ***On Portfolio Diversification***

Early in their conversation, Charlie wanted to know how many different stocks we own for our clients. The answer must have proven sufficiently low as Munger referred to it as “very sensible” and then spent a few moments dismantling the idea that diversification is the key to investment success. Investors have been told to believe that diversification ensures future portfolio growth while providing safety in times of turbulence. This is absolutely false according to Munger.

From a prior speech, Charlie said, “The idea of excessive diversification is madness... a person with almost all [of their] wealth invested long-term in just *three* fine domestic corporations is securely rich. And why should such an owner care if at any time most other investors are faring somewhat better or worse?”

“I think it can be a rational choice, in some situations, for a family or a foundation to remain 90% concentrated in *one* equity. Indeed, I hope the Mungers follow roughly this course... Ben Franklin required just such an investment practice for the charitable endowment created by his will. Why not thus imitate Ben Franklin? After all, old Ben was very effective in doing public good. And he was a

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- Charlie Munger

pretty good investor, too.”

“Our culture is very old-fashioned, like Ben Franklin’s or Andrew Carnegie’s... A lot of the businesses we buy are kind of cranky and old-fashioned like us... Berkshire is full of people who have a peculiar passion for their own business. I would argue passion is more important than brain power. [That’s easy for someone with Charlie’s brain power to say!] We are more disaster-resistant than most other places.”

### **On Berkshire Hathaway**

As Charlie told Darren:

“Berkshire is vastly underappreciated for how great it is. Are the companies owned by Berkshire better, the same, or worse than the average publicly traded company? I can answer that: they are of far better quality. Can they grow faster and earn higher returns on capital than other companies the same size? Absolutely they can. So you have this business [Berkshire] of much better businesses that can grow for a long time. And I would argue that even the larger businesses can grow faster than many other large businesses that Berkshire does not own. Berkshire’s utility business is protected and has so many opportunities for future investment. That’s something that will grow for a very long time. Then think about Burlington Northern. There’s really no risk to the railroads. They may have an off year, but there’s no risk of failure. Berkshire is simply loaded with businesses where there is little risk because they are such better businesses.”

Warren and Charlie grew Berkshire at an astonishingly brisk pace in the 1970s, 80s and 90s. Today’s Berkshire, due to its larger size, cannot grow as rapidly as it did in prior decades. “That [rate of growth] will never happen again,” Charlie said. “So some people know this and will sell their Berkshire shares. They don’t know what they’re doing! Berkshire will still grow for a very long time because it is a collection of better businesses than you can buy elsewhere.”

Charlie reiterated several times that “the culture at Berkshire is not going to change.” As he has said elsewhere, “Berkshire is drowning in money. We have great businesses pounding out money. If the stock went down, Berkshire could buy it back. There’s no reason to think it will go to hell in a bucket, and I think there’s reason to believe it could go quite well. I’d be horrified if it isn’t bigger and better over time, even after Warren dies.”

“If anyone would have a reason to worry, it would be me [by virtue of his and his family’s large and concentrated stake in Berkshire shares]. But having known the Buffett family for decades, I say to you, ‘Don’t worry about it.’”

### **On the Financial Disservice Industry**

Munger disdains Wall Street’s orthodoxy not just as it pertains to diversification but to several other concepts that strike him as ludicrous. The Efficient Market Hypothesis and Modern Portfolio Theory<sup>1</sup> are two ideas that are easy for investment advisors to sell to individuals.

“I think the reason why we got into such idiocy in investment management is best illustrated by a story that I tell about the guy who sold fishing tackle. I asked him, ‘My god, they’re purple and green. Do fish really take these lures?’ And he said, ‘Mister, I don’t sell to fish.’”

As for sales practices, Darren and Charlie discussed the Wells Fargo scandal. Munger has said before, “Show me the incentive and I will show you the outcome.” This can be applied to the improper practices at Wells Fargo. Charlie referred to the behavior of the Wells Fargo employees several times as “stupid” and he appeared dismayed.<sup>2</sup>

Darren asked if Warren was disappointed, if not angry, about the fiasco. Charlie swatted away the notion: “Warren does not get angry. He just doesn’t. It’s not that he isn’t capable of it, it’s that he’s seen everything so many times before that he isn’t surprised by anything. His expectations are appropriately set so when someone does what

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*- Charlie Munger*

someone will inevitably do, then he has no reason to be surprised.”

Last quarter, Buffett stated, “The former [Wells Fargo] CEO created an incentive system with perverse consequences. [Once the bad behavior began,] He should have acted quickly [to stop it] but he did not.”

### ***Know the Boundary of Your Knowledge***

Both Buffett and Munger speak frequently about the advantage of knowing one’s limitations. “If you have competence, know the edge. It wouldn’t be a competency if you didn’t know where the boundaries lie... There are a lot of things we pass on. We have three baskets [on our desks]: in, out, and too tough...We have to have a special insight, or we’ll put it in the ‘too tough’ basket.”

“Confucius said that real knowledge is knowing the extent of one’s ignorance. Aristotle and Socrates said the same thing. Is it a skill that can be taught or learned? It probably can, if you have enough of a stake riding on the outcome... Knowing what you don’t know is more useful than being brilliant.”

And one should not try to fake their way through this. Though there is this enjoyable story told by Charlie:

“There’s a famous story about [the physicist] Max Planck which is apocryphal: After he won his [Nobel] prize, he was invited to lecture everywhere, and he had this chauffeur that drove him around to give public lectures all through Germany. And the chauffeur memorized the lecture, and so one day he said, ‘Gee Professor Planck, why don’t you let me try it as we switch places?’ And so he got up and gave the lecture. At the end of it some physicist stood up and posed a question of extreme difficulty. But the chauffeur was up to it. ‘Well,’ he said, ‘I’m surprised that a citizen of an advanced city like Munich is asking so elementary a question, so I’m going to ask my chauffeur to respond.’”

“In this world,” concludes Munger, “we have two kinds of knowledge. One is Planck knowledge,

the people who really know. They’ve paid the dues, they have the aptitude. And then we’ve got chauffeur knowledge. They have learned the talk. They may have a big head of hair, they may have fine temper in the voice, they’ll make a hell of an impression. But in the end, all they have is chauffeur knowledge. I think I’ve just described practically every politician in the United States.” And, we know Charlie agrees, countless professionals in the financial services industry.

### ***On Lifelong Learning***

Munger’s successful formula since childhood has been simple: to learn as much as possible. “I constantly see people rise in life who are not the smartest, sometimes not even the most diligent, but they are learning machines. They go to bed every night a little wiser than they were when they got up and boy does that help, particularly when you have a long run ahead of you.”

To be a successful investor, vast knowledge and awareness of its boundaries must be paired with the proper mindset. “You need to keep raw irrational emotion under control. You need patience and discipline and an ability to take losses and adversity without going crazy.” Munger pulls no punches: “If you stay rational yourself, the stupidity of the world helps you.” Charlie admits that finance is “a hard subject to be rational about.” But, “there is nothing wrong with keeping your head when all about you are losing theirs – Kipling was right.”

As he told Darren about Warren: “Remember, he’s lived a very successful life as a result of the stupidity of others.”

### ***On the Future Economic Environment***

Though opportunities to capitalize on misbehavior in markets will continue to exist over time, Munger is less sanguine on the future prospects for the U.S. economy. In this way, he differs from his partner, Buffett. He told Darren:

“In time, life will get tougher in the U.S. Future generations will probably have a more difficult time

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*- Charlie Munger*

than we've seen in the past. Our economic future will be much more difficult. It will be harder to make money." Charlie's solution? "You would be very smart not to acquire large spending habits."

As he has previously said, "One of the great defenses if you're worried about inflation is not to have a lot of silly needs in your life. You don't need a lot of material goods."

"There once was a man who became the most famous composer in the world but was utterly miserable most of the time, and one of the reasons was because he always overspent his income. That was Mozart. If Mozart can't get by with this kind of asinine conduct, I don't think you should try."

### ***Live a Good Life: Be Good to Others***

A young shareholder at Berkshire's annual meeting once asked him how they could follow in his footsteps, with an emphasis on generating the wealth that Charlie has earned during his lifetime. Munger said the following:

"We get these questions a lot from the enterprising young. It's a very intelligent question: You look at some old guy who's rich and you ask, 'How can I become like you, except faster?' Spend each day trying to be a little wiser than you were when you woke up. Discharge your duties faithfully and well. Step by step you get ahead, but not necessarily in fast spurts. But you build discipline by preparing for fast spurts... Slug it out one inch at a time, day by day. At the end of the day – if you live long enough – most people get what they deserve."

Charlie may even believe that our capitalist system has provided him with more than he deserves. "To the extent that all I've done is pick stocks that have gone up and sat on my [behind] as my family got richer, I haven't left much contribution to society. I guess it's a lot like Wall Street. The difference is, I feel ashamed of it. I try to make up for it with philanthropy."

Munger's philanthropic efforts have and will continue to be immense. Among a variety of others, he is known to support hospitals, women's rights,

and educational institutions.

"You don't want to be like the motion picture executive who had many people at his funeral, but they were there just to make sure he was dead. Or how about the guy who, at his funeral, the priest said, 'Won't anyone stand up and say anything nice about the deceased?' and finally someone said, 'Well, his brother was worse.'"

So how does Charlie want to be remembered?

"I like to ask Warren what he wants to be remembered as, and he says a teacher. Who else in America who is a CEO says he wants to be remembered as a teacher? I like it."

"I wouldn't mind being remembered as a teacher, but I won't be. I may be remembered as a wise ass!"

*DISCLAIMER: The above article is not a recommendation to purchase or to hold an investment in any securities of Berkshire Hathaway. It should not be assumed that any investment in Berkshire Hathaway will prove profitable. Charles Munger is the long-time Vice Chairman of Berkshire Hathaway. His comments may include forward-looking statements and his statements are not guarantees of future performance. Mr. Munger's comments represent his own opinion and are for informational and educational purposes only.*

### **COMPOSITE PORTFOLIO UPDATE**

During the quarter, we initiated a purchase of the shares of Bayer. This German-based life sciences company traces its roots back to 1863 as a synthetic color manufacturer for the textile industry. Throughout the company's history, scientists at Bayer invented numerous materials and pharmaceuticals, including polyurethane, polycarbonates, and, of course, Aspirin. Current branded pharmaceuticals include Xarelto, Eylea, Cipro, and Levitra. A sampling of over the counter health products include Aleve, Alka-Seltzer, Claritin, Dr. Scholl's, One-A-Day, Coppertone and Advantage (for pets).

Last year, the U.S.-based crop science company Monsanto agreed to be acquired by Bayer. Together with Bayer's seed protection business, the combined company will form a global leader in the agriculture

industry. On a pro-forma basis, the new company will be split almost evenly between crop sciences and human health products and will enjoy tremendous geographic distribution of its well-diversified product offerings.

We believe that the shares of both Bayer as-is and the pro-forma combined company are undervalued relative to its peers. At the time of our purchase, we secured a dividend yield of nearly 3%. We expect future earnings and dividends to rise, helping to grow the value of our stake in this company.

### CREDITS

Darren C. Pollock, David A. Horvitz, and Dixon Karmindro authored this issue of *Investment Values*.

### CHEVIOT COMPOSITE DISCLOSURE

*Cheviot's Balanced Portfolio Composite (the "Composite") includes all fully discretionary, fee-paying accounts over \$250,000 (Cheviot's new account minimum balance is \$1,000,000). The Composite assets are allocated principally among the following asset classes: equities (common stocks), fixed income (bonds) and money market funds (cash).*

*In the Composite, client accounts are combined for performance reporting purposes to provide a "Composite" return. The Composite represents actual money invested for clients.*

*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 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 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 Cheviot's current expectations, estimates, projections, assumptions, targets, and beliefs. 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.*

*The performance results displayed herein represent the investment performance record for the Balanced Portfolio Composite, a composite of balanced accounts managed by Cheviot Value Management, LLC, a registered investment adviser under the Investment Advisers Act of 1940. The*

*Composite returns are total, time weighted returns expressed in U.S. dollars and include the reinvestment of dividends and other earnings and the deduction of transaction charges and investment advisory fees. The time period commencing July 1, 2000 is used as a standard measuring point as that is the date current investment personnel have been active in portfolio management.*

*The graph on page 8 titled Cheviot Composite Equities vs. S&P 500 compares all stocks within the Cheviot Balanced Composite vs. the S&P 500 Index and the Wilshire 5000 Index (both all-stock benchmarks). Accounts managed by Cheviot are not allocated 100% to stocks at all times, thus no management fees are applied to the data comprising this graph. By describing the performance of Cheviot's selected stocks only, this graph seeks to provide a more apples-to-apples comparison to the S&P 500 and Wilshire 5000.*

*The S&P 500 Index is a market capitalization weighted index of 500 of the largest U.S. companies. The returns for the S&P 500 Index are calculated on a total return basis with dividends reinvested. The S&P 500 Index is not available for direct investment. The Wilshire 5000 Index Fund is a fund that closely follows the performance of the Wilshire 5000 Total Market Index. Its return is calculated on a total return basis with dividends reinvested.*

*Dalbar Inc.'s quantitative analysis of investor behavior produces the actual performance generated by all investors, professional and individual, in U.S. stock mutual funds. The graph on page 8 illustrates this performance over time. This data is made available once per year, in March, to reflect the prior year's actual performance earned by real investors.*

*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 Cheviot Balanced Composite has been examined by independent verifiers for the years 2000 through 2011. A copy of this examination report and further details of our composite are available upon request.*

*Investment Values is intended to be a source of educational information to Cheviot clients about investments and related topics. Comments about specific securities are NOT intended to be recommendations that readers purchase or sell such securities. Such comments are 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.*

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### NOTES

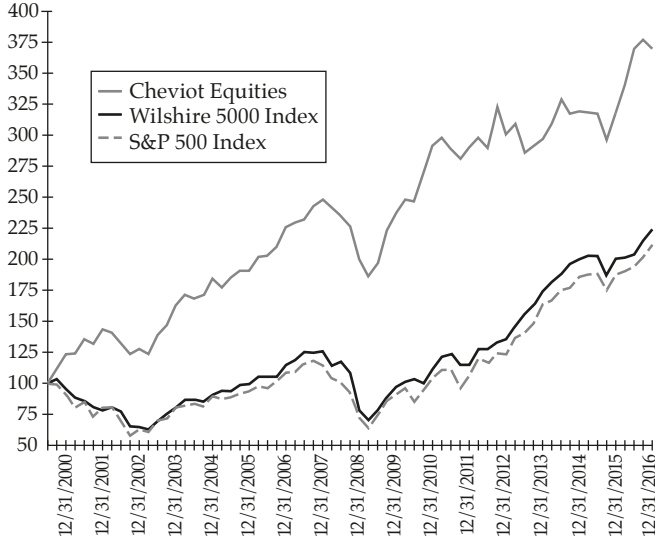
<sup>1</sup>"EMH" states that market prices accurately reflect underlying value, therefore there is no advantage that can be gained through the value investing approach; "MPT" is another hypothesis proposing that portfolio returns can be optimized according to the correlation among assets within the portfolio.

<sup>2</sup>Berkshire Hathaway is the largest shareholder of Wells Fargo. Employees were paid commissions to open new accounts – and had no authorization to open more than two million of them. Wells Fargo will pay a fine of \$185 million and incur "tens of millions" of dollars' worth of costs to improve the company's procedures and try to restore its reputation.

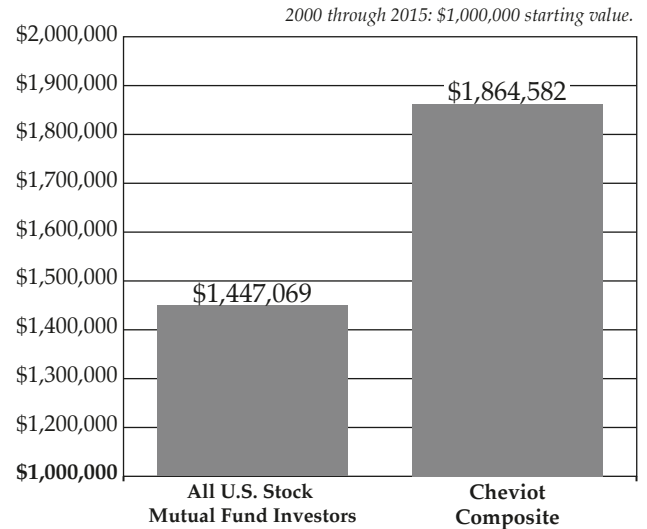
# CHEVIOT VALUE MANAGEMENT, LLC

Investment Management • Retirement Planning • Taxation Mitigation • Charitable Giving  
Estate Planning • Insurance Advice • Risk Management • Retirement Benefits

## Cheviot Equities Long-Term Performance



## Investors in U.S. Stock Mutual Funds vs. Cheviot



### *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*, *The Wall Street Journal*, *Money Magazine*, Yahoo! Finance TV, Fox Business, and the Business News Network.

We maintain the most 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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