

# INVESTMENT VALUES

Issue Number 125, January 2018

*"Markets make opinions."* - Richard Russell

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## OUR INVESTMENT OUTLOOK

We stated one year ago that the market was behaving as if, with apologies to Benjamin Franklin's maxim, "In this world, nothing can be said to be certain, except death and tax *cuts*." And the market indeed rallied throughout 2017 as if tax cuts were imminent. Finally, the long-anticipated new tax bill was signed into existence just before year-end. It seeks to lower taxes for a large number of individuals and businesses. To the extent that tax savings are spent to purchase goods and services, the impact of the tax cuts should provide a modest boost to economic activity and justify a portion of the stock market's optimism. On average, after-tax corporate profits will jump this year, serving to make stocks more attractive.

A few dozen corporations recently grabbed headlines by paying year-end bonuses to their employees in the wake of the newly-signed tax bill. A large number of U.S. companies are also describing their intent to use the tax break to repurchase their own outstanding shares and debt. By comparison, there has thus far been little discussion about imminent plans to grow their businesses.

Current U.S. economic conditions are in the "Goldilocks" range, *i.e.*, not too hot and not too cold. This is a perfect backdrop for the Federal Reserve

to continue gradually to raise interest rates in the U.S. from levels that remain well below normal. And this is exactly the path we expect from new Fed Chairman Jay Powell based on his prior speeches and voting record as a member of the Fed. Outgoing Chairwoman Janet Yellen presided over a relatively tranquil four-year term in which the economy and financial markets grew steadily. The history books will reflect kindly upon Yellen as the person who engineered the first series of rate hikes after several years of interest rates being held at the emergency level "zero-bound."

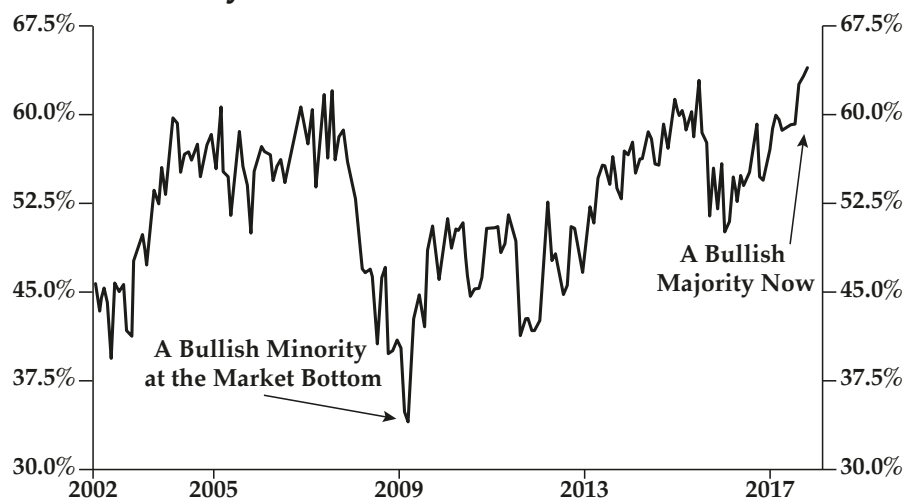
Extrapolating the recent past into the future (as they typically do), investors expect a continuation of rising prices and financial market tranquility on the heels of perhaps the least volatile year ever for the U.S. stock market. As of the fourth quarter of last year, amidst higher stock prices, U.S. investors were more bullish than any other time this century. During the fourth quarter of 2017, nearly two-thirds of respondents to Michigan University's stock market sentiment survey expected stock prices to rise in the year ahead. (What did they expect during the 2008-2009 market crash when prices were at their lowest level of the past 20 years? Then, roughly two-thirds wrongly believed that stock prices would in one year be lower.) "Markets make opinions," was a favorite phrase of the insightful market watcher Richard Russell. High prices breed optimism for higher future prices – as is the case today. The inverse is also true.

However, "The market is there to serve you, not to guide you," said Benjamin Graham, the father of value investing and Warren Buffett's teacher.

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*Cheviot is a completely independent financial advisory firm. We put our clients first in everything we do.*

## University of Michigan Consumer Survey: Probability of Stock Market Increase in Next Year



When intelligent investment opportunities exist, they should be purchased. To avoid the pitfalls made all too often by others, stocks should not be bought simply because they have risen. We believe incoming Fed Chairman Powell is loathe to upset the apple cart early in his leadership role at the Fed and he will not set out to raise rates too quickly. Reflecting this, investor enthusiasm is palpable. But stock market valuations are higher than normal and we want our portfolios to be intelligently balanced. This should enable us to continue to enjoy further gains in the event stock prices continue to rise while also maintaining the ability to make meaningful acquisitions during any market downdraft.

### ***BITCOIN AND THE CRYPTOCURRENCY CRAZE***

Bitcoin, whose invention in 2009 is shrouded in mystery, is a digital currency that has dominated the interest of both technophiles and speculators alike. But what is it and how does it work? And what are potential outcomes for it as a speculation?

Before Bitcoin and the interchange through which it is exchanged, the blockchain (a technologically advanced ledger), all non-cash transfers of money were exchanged via a trusted third party such as a bank whereby that “middle man” ensures that funds are electronically debited from one account and credited to another. Checks, credit cards, and wire transactions all work this way. In our country, so trusted is this middle man that it is uncommon

for us to ask, “What would happen if the bank was corrupt? Faulty? Too expensive? What would happen if the government seized for itself all of the assets of the bank?”

Enter blockchain technology. Using complex algorithms, blockchain technology allows currency (Bitcoin being the most widely recognized) to be exchanged directly between users and stored on a network of computer servers around the world. This circumvents the need for a centralized repository such as a bank. Bitcoin and hundreds of other so-called cryptocurrencies

are exchanged using cryptography, or encryption technology, and, like cash, transactions occur anonymously, supposedly without the knowledge of third parties like law enforcement or taxation authorities.

Since Bitcoin is exchanged directly between users, proponents argue there is no risk that it can be confiscated by a government (though it is held online only and there are numerous examples of digital currency being stolen and, unlike money stolen via credit card fraud, theft of cryptocurrency, also like cash, is un-refundable). For this reason and others, Bitcoin was an attractive medium of exchange for criminal activity and for citizens of countries whose governments either seized bank accounts or inflated away all value of their currency. In recent months, however, speculators the world over have poured money into Bitcoin, pushing its price higher – and more rapidly – than any bubble of any asset in history.

Other than purchasing Bitcoin, the cryptocurrency can be “mined” – a technical process requiring tremendous computing power in which warehouses full of computer servers validate and record Bitcoin transactions to the blockchain. The reward for recording Bitcoin transactions to the blockchain and for solving highly complex computational problems is a small transaction fee and a subsidy of newly created Bitcoin. Mining for Bitcoins becomes increasingly difficult as more servers compete with one another and as newly created Bitcoins are

released less frequently over time. Bitcoin is limited to 21 million coins by the year 2140.

Interestingly, the computing power necessary for validating transactions and mining the cryptocurrency uses enormous amounts of energy: as of December 2017, last year's energy use for "mining" was greater than that of all of Denmark's electricity needs. At this pace, by 2019, crypto-mining will require the equivalent of half of all electricity used in the U.S. As of year-end, more than half of all Bitcoins are mined in China and approximately half of the energy used is sourced by coal mining.

Bitcoin's popularity has spurred the creation of nearly 1,400 cryptocurrency alternatives – so-called *altcoins* – including large competitors such as Litecoin, Ethereum, and Ripple. Others may be smaller but make up for it with amusing names such as Einsteinium, Byteball Bytes, Mooncoin, and Dragonchain. Dentcoin hopes to be the preferred currency of choice for consumers seeking to pay their dental bills. The idea that Bitcoins will remain scarce because only a finite number will ever be mined is somewhat diluted by the creation of separate and new altcoins including something called "forks," such as Bitcoin Gold, Bitcoin Cash, and other Bitcoin derivatives.

Are these cryptocurrencies the new money, or are they experimental, eventually useless, and purely speculative? Advocates argue that cryptocurrency is the monetary system's equivalent of the technologies behind Uber and Airbnb that disrupt the status quo, redefining their respective industries. As more retailers accept cryptocurrency and as it begins trading more widely on financial exchanges, governments will begin regulating it which could result in a flood of institutional money purchasing Bitcoin and its altcoin cousins. On the other hand, in a bid to thwart money laundering and terrorism financing, the European Union is pushing through legislation that will increase transaction transparency. It might not be long before the U.S. government designates businesses in the crypto industry as financial institutions, resulting in diminished privacy, similar to the IRS's recent request of Coinbase, a crypto exchange, to identify its account holders.

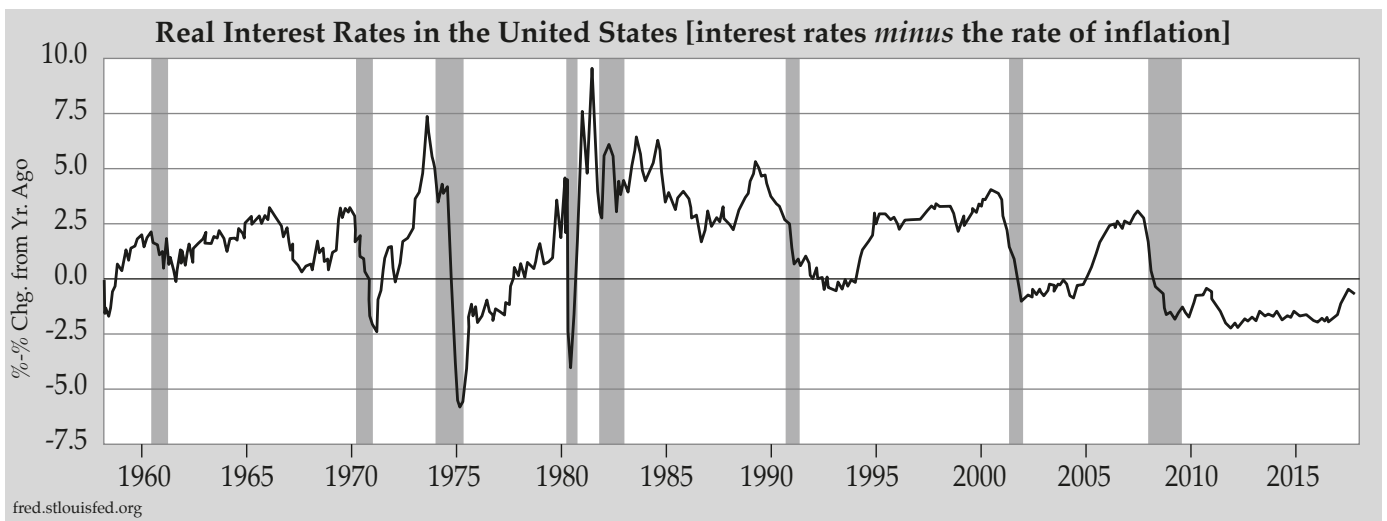
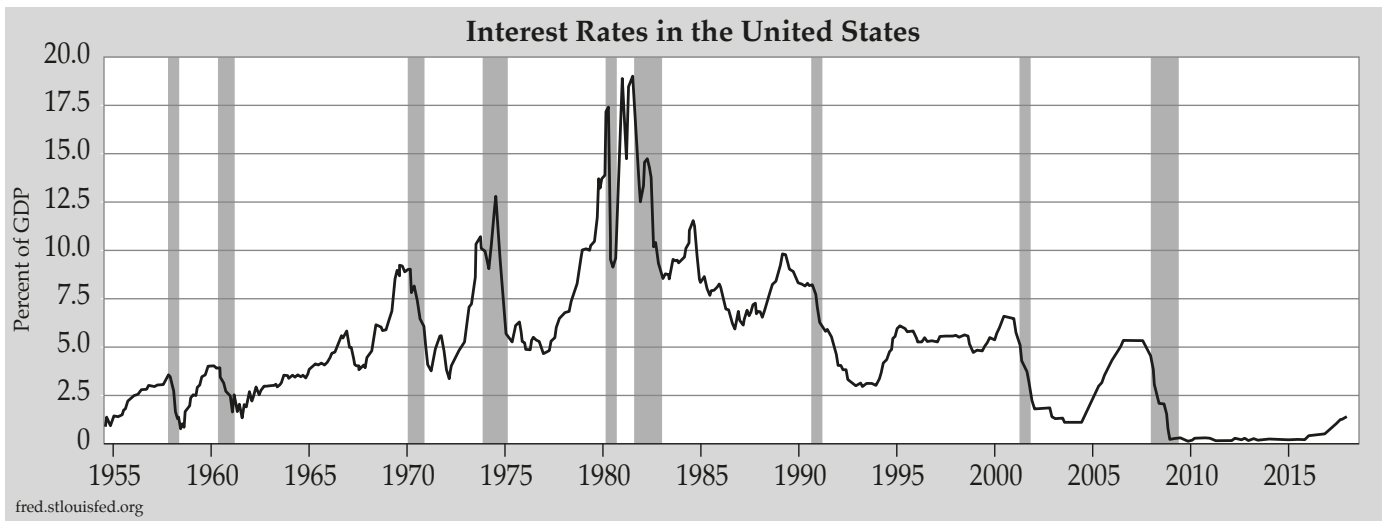
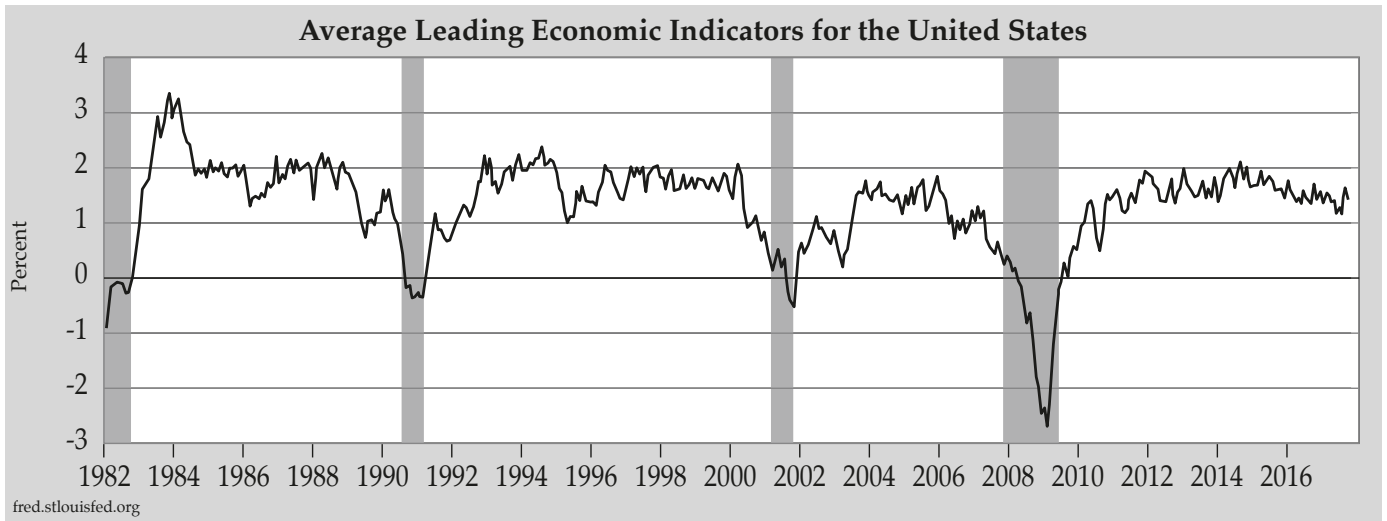
Investments in companies that merely mention a working relationship with cryptocurrencies are suddenly in great demand. On the day the Rich Cigar Company changed its name to Intercontinental Technology and stated its intention to begin mining for cryptocurrency, its stock rose from \$0.03 to \$0.90. Shares of The Crypto Company (CRCW) soared from \$20 per share last November to more than \$700 two weeks later after the company revealed that it would be dabbling in cryptocurrencies. As of September 30, 2017, aside from the sales of some cryptocurrency, the former sports bra company had a total of \$6,000 of revenues (all of which were uncollected). In December, to acquire all outstanding shares of CRCW, the buyer would need to pony up the astounding sum of \$12 billion. Trading in the shares was suspended in mid-December. UBI Blockchain Internet, formerly JA Energy, has no revenues but the name change saw its share price spike 1,000%. In a regulatory filing showing insider executives' desire to sell more than 70 million shares (get out while the selling is good), the company listed a telephone number that is no longer in service.

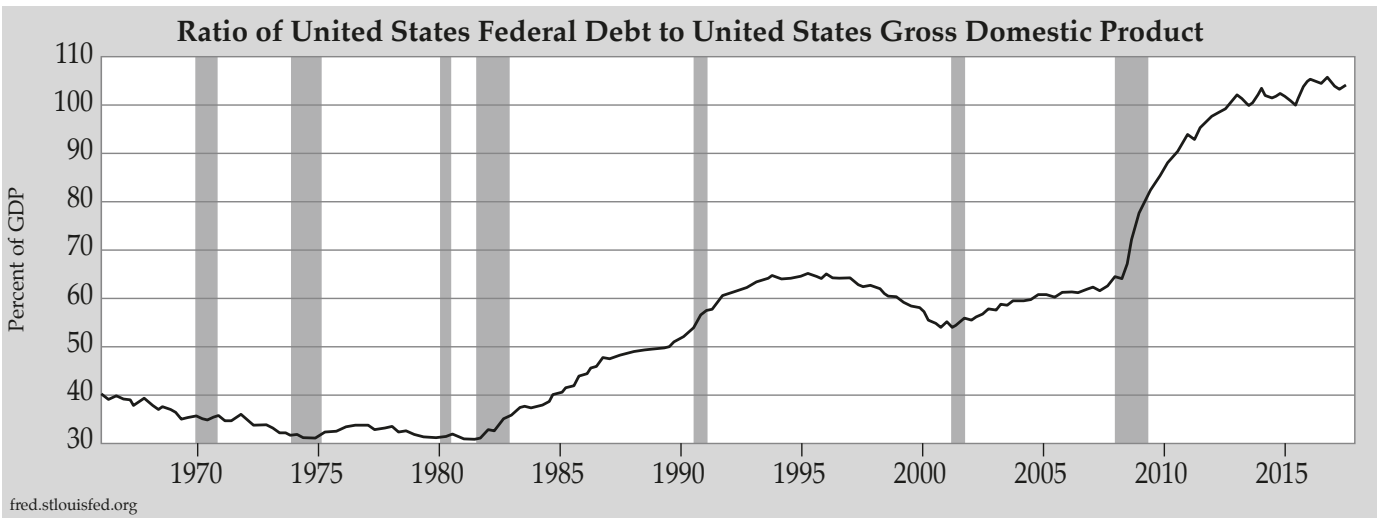
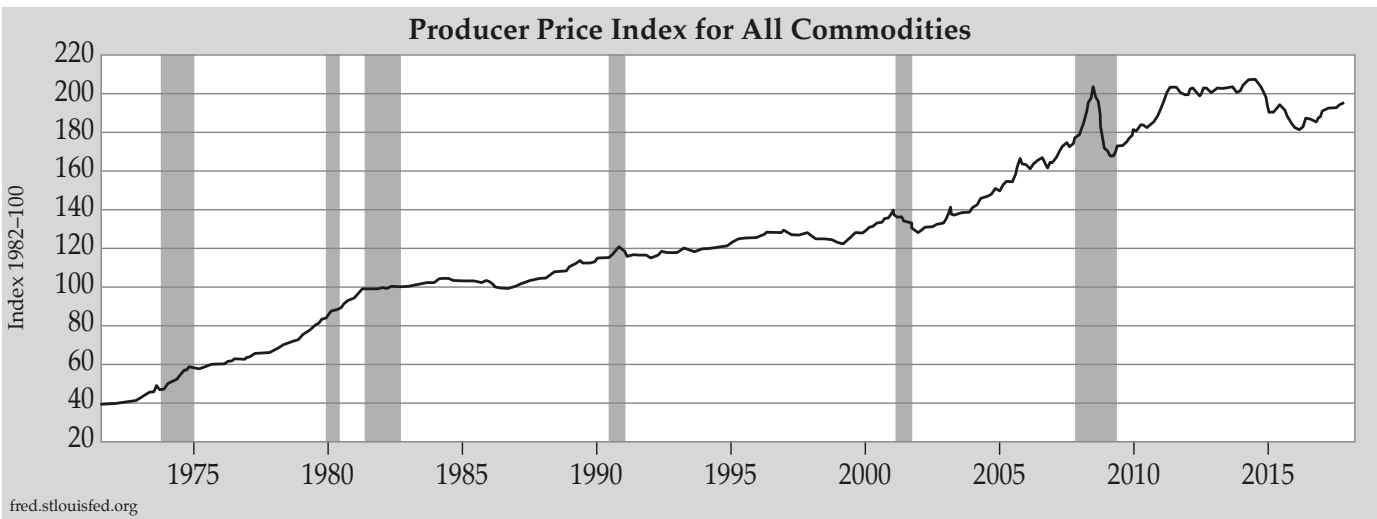
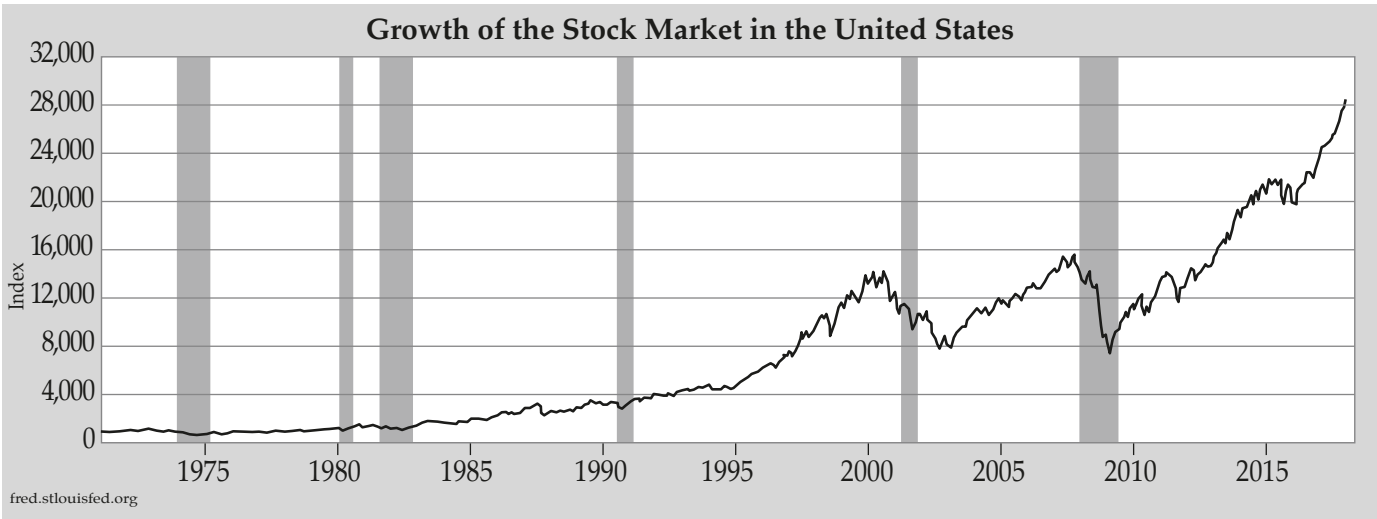
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### **ON THE NEXT TWO PAGES...**

...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.

# Cheviot's Graphical Interlude: Charting the Progress of the U.S. Economy and Financial Markets





-Continued from Page 3

The co-founder of Litecoin stated in December that he will be selling all of his cryptocurrency. This is reminiscent of the late stages of the 1990s stock market mania when anything with a dot-com attached to it attracted rabid buyers who pushed up its share price.

Similarities to the tech bubble and pending or eventual governmental legislation notwithstanding, there remains a passionate contingent that believes that Bitcoin and its brethren will continue to soar in value. The always-thoughtful Murray Stahl of investment firm Horizon Kinetics refers to cryptocurrencies as a “civilizational change” and he expects Bitcoin to eventually become a valid global currency. And another all-around bright guy, famed fund manager Bill Miller, states that until now “There really hasn’t been any technological innovation in money – ever.”

“We are in the middle of a speculative mania,” adds Mike Novogratz, a former hedge fund manager. “And phase one of this whole crypto decentralized revolution is just selling the story. None of these protocols are going to be ready for prime time for at least two to three years. And so we’re selling the story about what the future’s gonna be.” Amid Bitcoin’s price turbulence, Novogratz decided in mid-December to shelve plans of opening a fund strictly to invest in cryptocurrencies.

Crypto fervor possesses other aspects akin to prior speculative manias. Some Bitcoin-believers are disavowing heretofore accepted rules of investing in order to pledge their allegiance to crypto. Says Fidelity fund manager Mark Schmehl, “I don’t believe in Warren Buffett. I care about new things, things that are innovative, that are growing, that are changing the world.” Most rules of investing, the Fidelity manager says, are “total baloney.” Says venture capitalist, former Facebook executive, and CNBC favorite Chamath Palihapitiya: “In the next 20 years, [Bitcoin will be worth] a million dollars a coin.”

Despite the parabolic rise in Bitcoin’s price, the number of skeptics are plentiful. “A nice round number, that doesn’t sound like there’s much analysis behind it,” says financial markets guru Jeffrey Gundlach. “The million dollar number... it’s getting to the point where you’re trying to get notoriety for

how high a prediction you can make.” He predicts, “If you short Bitcoin today, you’ll make money [over the longer term]. Can it go higher [in the near-term]? Of course. It’s a massive momentum play... There are even crypto-kitties! Something’s wrong here.”

“It’s a Beanie Baby,” says Jim Chanos, a famed financial sleuth who was one of the first to sniff out fraud at Enron and Tyco (and profit from their declines). Another mania like Beanie Babies was the tulip craze in Holland in the years 1636-37. Tulip bulb prices rose by several thousand percent over three months only later to decline back to their original levels. “Bitcoin is like anything else – it’s worth what people are willing to pay... The tulips were worth what people were willing to pay for them,” says legendary investor Stan Druckenmiller.

“Super-parabolic price movements often contain their own premonition, namely that the end is nigh for the mania,” writes Edward Chancellor, author of [Devil Takes the Hindmost: A History of Financial Speculation](#). “When the tulip boom ended, the price of Gouda bulbs fell from 60 guilders to what would have been the equivalent of around 10 cents, a price decline of 99.8%. Given that Bitcoin has soared higher than humble tulips and has even less intrinsic value, a decline of similar magnitude is not out of the question.”

Gundlach provides a big picture view: “I don’t think cryptocurrencies are legit. I don’t think it will ultimately serve the purpose people believe it will serve for a couple of reasons: I don’t think they’re unhackable. I know the 20-somethings who know all this stuff, the masters of the universe, they tell me I’m dead wrong. But I’m a philosopher and I believe that what can be done can be undone. So I think ultimately they won’t serve a purpose. And beyond that, I don’t think they will free you of the government’s control. And I think that’s one of the reasons why people believe in them. I actually think it’s the other way around. I think the government will be particularly able to control it. No more suitcases full of hundred dollar bills. Everything [with cryptocurrencies] can be followed... And I believe that governments will fight tooth and nail if they can’t control them in any way, they’ll fight tooth and nail to suppress them because there’s a complete inconsistency between a cryptocurrency

world and a world of nation states.”

We turn to our favorite modern-day business-man-philosopher and overall polymath, Charlie Munger, Warren Buffett’s partner at Berkshire Hathaway for more than 40 years. In December, Munger pulled no punches: “I think it’s perfectly insane to even pause to think about them [cryptocurrencies]... Gold has some store of value because man has no way of inventing more gold or getting it very easily. So it has the advantage of rarity. But believe me, man is capable of somehow creating more Bitcoin. They tell you they’re not going to do it but they mean they’re not going to do it unless they *want* to... When there’s enough incentive, bad things will happen.”

He continues: “It’s bad people, a crazy bubble, a bad idea luring people into the concept of easy wealth without much insight or work... You know, crooks, crazies, egomaniacs... [in your life] there’s a whole lot of things that aren’t going to work for you. Figure out what they are and avoid them like the plague – and one of them is Bitcoin... People who are promoting Bitcoin – I don’t even want them to know my address.”

“I’m not rash enough to predict when or at what price Bitcoin will top out. But it’s a mania, and eventually this bubble will pop amid tears,” says Vito Racanelli of *Barron’s*. “Where have all the penny-stock hustlers gone? It seems to me they’ve all moved on to cryptocurrencies.” In a separate piece in *Barron’s*, Racanelli quotes us: “After the Bitcoin bubble bursts, the world’s new dominant currency will be Starbucks gift cards.”

## CREDITS

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

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## 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.

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We have decades of independent and unbiased experience, serving clients since 1985.

We invest for ourselves and our families the same way we invest for our clients: We "eat our own cooking."

We do not sell any investment "products" nor are we affiliated with any other financial service companies that do. There are no hidden fees.

We have been recognized by the financial industry's leading publications including, *Barron's*, *Bloomberg*, *The Wall Street Journal*, *Money Magazine*, *Fox Business*, and the *Business News Network*.

We maintain 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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