

INVESTMENT VALUES

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"The overriding question is, 'How is American business going to do over your investing lifetime?'" - Warren Buffett

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WARREN BUFFETT'S WISDOM, 2018 EDITION

Those who have invested with us for decades know our style of investing owes much credit to the wisdom of Warren Buffett (and his teacher, Benjamin Graham, and Warren's partner, Charlie Munger). Among the many reasons we find his observations so astute is the fact that they are timeless. Whether the stock market is being chased by a wild bull or is being ravaged by a ruthless bear, Buffett's words of advice apply. Buffett and Cheviot possess similar views of the stock market – from its general purpose to how to navigate it – and we employ similar investment strategies to grow our clients' assets over time.

Currently, the stock market is trading near record levels. However, possible trade wars with countries in Asia, Europe, and even our neighbors, both north and south, among other political and economic fears, are raising concerns throughout the investment community that the tides may turn. Whenever there is a greater than normal focus on the short-term, it is often wise to revisit Buffett's time-tested investment principles. Herein we reproduce many of his insightful comments, mostly about how to view and evaluate stocks, compiled in the last few months

from 12 hours of Q&A sessions (two three-hour sessions on CNBC and the six-hour annual shareholder's meeting in the city of Berkshire Hathaway's headquarters – Omaha, Nebraska), spliced together for cohesiveness and by theme, with only the most minor edits for clarity.

As Buffett began the Q&A for Berkshire's annual shareholder's meeting, he made one of the most insightful – yet obvious – observations: "As you listen to the questions and answers we give today [that are so heavily focused on current events], just remember that the overriding question is, 'How is American business going to do over your investing lifetime?'"

"I would like to spend just a couple of minutes giving you a little perspective on how you might think about investments... Imagine yourself back on March 11th of 1942."

The U.S. was embroiled in World War II for the prior three months, "a war which we were losing at that point," says Buffett. "The newspapers were filled with bad news from the Pacific... We were in trouble, *big trouble*, in the Pacific. It was only going to be a couple of months before the Philippines fell."

The share price of Cities Service, a company that the 11 year-old Warren had been following, was falling precipitously. Shares were priced at \$84 the year before and were below \$40 now. Warren thought it was the time to buy. He bought three shares at \$38.25. As the war raged on, the shares continued to fall – all the way to \$27. "And walking to school with my sister, who also wanted to buy three shares because I was buying it – she hated to

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

see me get rich while she wasn't getting rich – and having her point out that this stock was going down every day, when it got back up to \$40 and we each had a chance to make \$5 of profit, I thought, 'You know, [if I sell] now my sister will again consider me a genius and I will have \$5 more. How could life be any better?!"

"So, then I watched it go to \$200 after selling it at \$40."

This provided a lesson that Buffett has employed increasingly over time: when you make the right investment, hold it for as long as possible. Do not let others convince you to sell it.

The "right investment" begins with seeing stock ownership as an ownership stake in an actual business, not as a piece of paper whose value is determined by the fickle evaluations and shortsightedness of countless speculators and talking heads on TV cumulatively known as "the herd."

A business's valuation increases or decreases over time based on management's ability to accommodate customers' demands for its products or services and in a way that creates a steady and reliable flow of profits to its shareholders. While this valuation certainly will fluctuate, normally it does not do so wildly over the course of a month, week, day, minute or second.

"If you own stocks like you'd own a farm or an apartment house, you don't get a quote on those every day or every week. You look at the business. And the value of American business depends on how much it delivers in cash to its holders between now and judgment day. And I don't think it changes by 10% in a two-month period [the way its stock could] if you're looking at it as a *business*."

"If you're investing, if I'm going to buy a half interest in a McDonald's franchise, I look to the business to determine whether I've made a good investment. And I'm concerned about whether we have new competition, how we do over the years. But it's the *business* I look at. When you're just looking at the price of something, you're not investing. You buy a farm, you look at how the farm does. If you buy a whole business, you're looking at how the business does. If you buy a part of a business, why shouldn't you look at how the business is going to do? People

get charmed by lots of action [in the stock market] and the fact that things are liquid and all of that."

"Some people should not own stocks at all because they just get too upset with price fluctuations. If you're going to do dumb things because a stock goes down, you shouldn't own a stock at all."

"Selling a stock because it goes down [is counterproductive]. If you buy your house at \$20,000 and somebody comes along the next day and says, 'I'll pay you \$15,000,' you don't sell it because the quote's \$15,000. You look at the house or whatever it may be. But some people are not actually emotionally or psychologically fit to own stocks. I think more of them, would be if [they would] get educated on what they're really buying, which is part of a business. And the longer you hold stocks, the less risky they become, whereas the longer the maturity of a bond, the more risky it becomes."

That stocks will decline at times is a given. But, as long as the price decrease is based on temporary bad news, there is no need to sell. In fact, negativity often provides the opportunity to buy more shares at appealing prices.

"Basically, I like bad news that isn't going to last. Bad headlines don't bother me... We've made the most money when there's been some temporary bad news... Bad news does not scare me." After all, "The best

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- Warren Buffett

chance to deploy [cash into investments] is when things are going down – obviously."

The extreme level of Warren Buffett's emotional detachment from his investments is unusual and admirable. This is a man who once said, "There's no reason we should become fearful if a stock goes down. If a stock goes down 50%, I'd look forward to it. In fact, I would offer you a significant sum of money if you could give me the opportunity for all of my stocks to go down 50% over the next month." And he meant it.

Buffett has long described how the proper temperament is more important to one's investing success than even a high I.Q. One's emotions can be swayed by things as frightening as world wars to coveting their neighbor's Porsche.

Says Buffett: "Most people get excited about a stock or about the market *after* it's gone up. Their

neighbor made a lot of money and they know they're smarter than their neighbor. It's very irritating to have a neighbor buy a new car and your spouse says, 'Is that guy smarter than you are or what?!' So, then they're enticed into the market at the wrong time."

"It's not easy psychologically for many people. But I've been teaching since I was 21. I taught my first class on investments, and I had a class last week with 11 schools, 220 students. And some of them get it and some of them don't. Now, people would rather gamble. The idea that you can double your money in six months, it's why people go to the races, why they go to Vegas. They even know the odds are against them and they still do it. It's a strong instinct to want to get rich fast. And I don't know how to do it."

"If we buy something, we don't have the faintest idea whether it's going to go up next week or next month or the next minute. But if I like it, we buy it."

What about bonds versus stocks?

"The one thing we know is we think that long-term bonds are a terrible investment at current rates or anything close to current rates."

"Long-term bonds at these rates, it's almost ridiculous when you think about it... The Federal Reserve [by targeting at least 2% inflation and being very gradual in raising rates after suppressing them to extremely low levels for nearly a decade] is telling you that they're going to do whatever's in their power to make sure that you don't get more than a half a percent a year of inflation-adjusted income."

Long-term bonds could see their attractiveness relative to stocks increase, but this is unlikely in the near-term: "If government bonds got to 15% yields like they were in 1982, then that's a different equation against stocks than exists now."

For someone with a multi-decade investment horizon, the choice for Buffett is easy: "If you had to choose between buying long-term bonds or equities, I would choose equities in a minute now. That doesn't mean I think the stock market is going to go up [immediately] or anything else. But if I were going to own a 30-year government bond or own equities for 30 years, I think equities will *considerably* outperform that 30-year bond over the 30 years. But I don't know what they're going to do in any day or week or month."

The Master vs. The Visionary

Buffett long ago coined an analogy that a good business is protected by a "moat." Warren's definition of "moat" is widely understood as the ability of a company to protect its competitive advantages and future profits in the face of ongoing competition. During Tesla's recent quarterly conference call, its CEO, Elon Musk, took a few bizarre, perhaps playful (nobody really knows), jabs at Warren's analogy of a moat. Warren and Charlie were asked about it during the weekend of Berkshire's shareholder meeting. Munger simply referred to Musk as being "ridiculous," and Buffett had this to say:

"There's certainly a great number of businesses where the pace [of change] has accelerated in recent years. There's been more moats that have become susceptible to invasion than seemed to be the case earlier. But there's always been the attempt to do it."

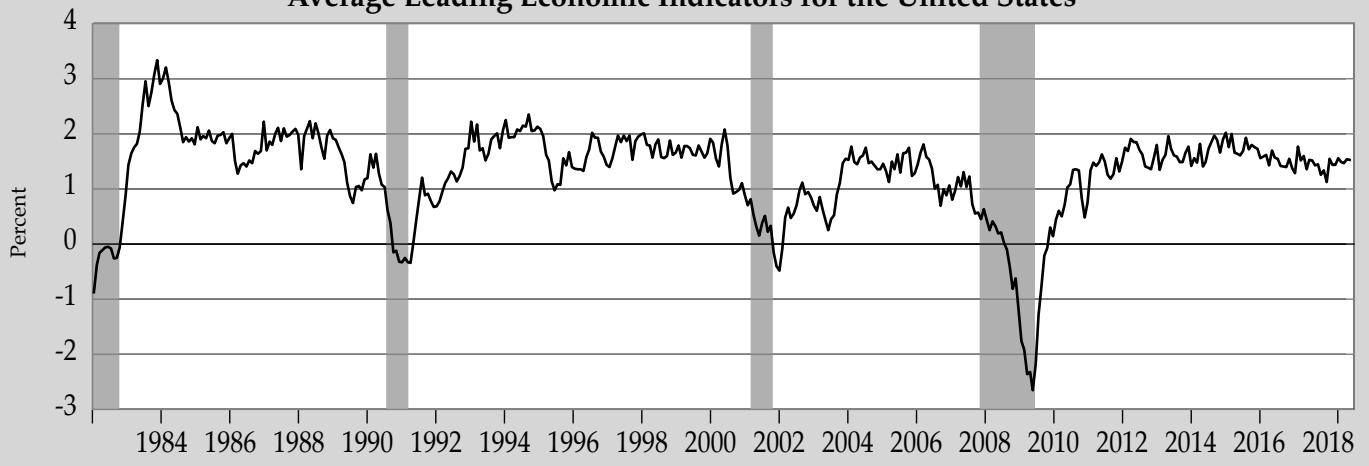
"And here and there, there are probably places where the moat is as strong as ever. But you should be working at improving your own moat and defending your own moat all of the time. And then Elon may still turn things upside down in some areas."

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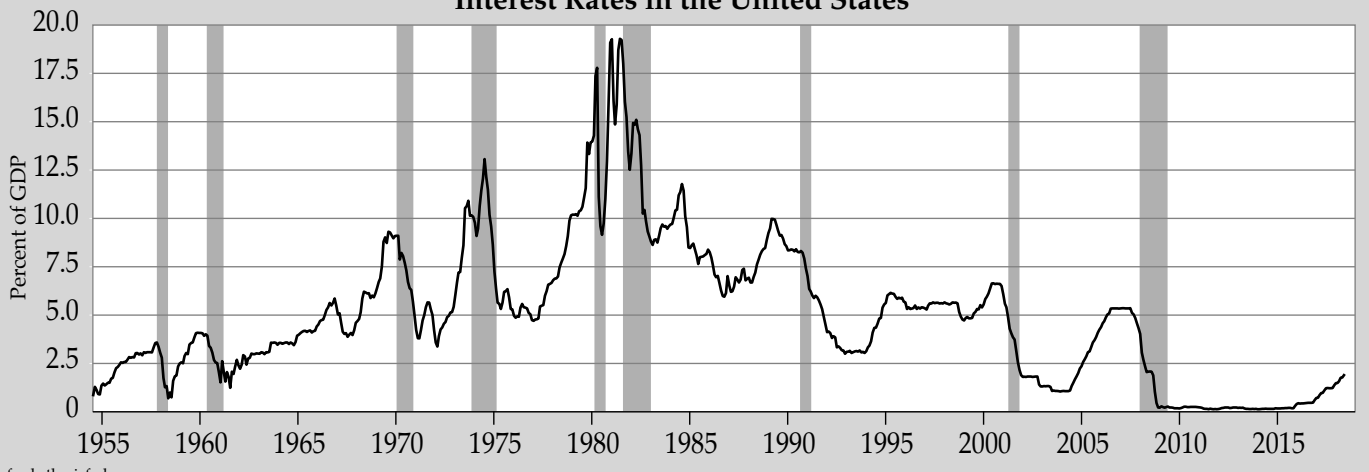
...We share a small sample of graphs that we believe paint a broad picture of U.S. economic activity and sentiment. Graph 1, Average Leading Economic Indicators, compiles ten important economic data points, including those related to manufacturing, employment, and consumer sentiment. Graph 2, Interest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



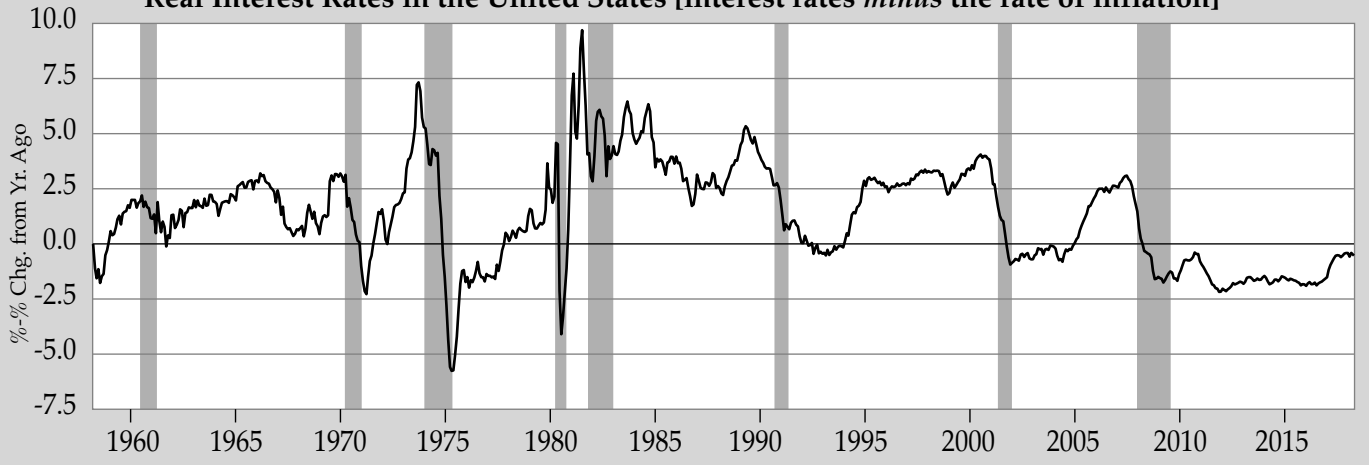
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Interest Rates in the United States

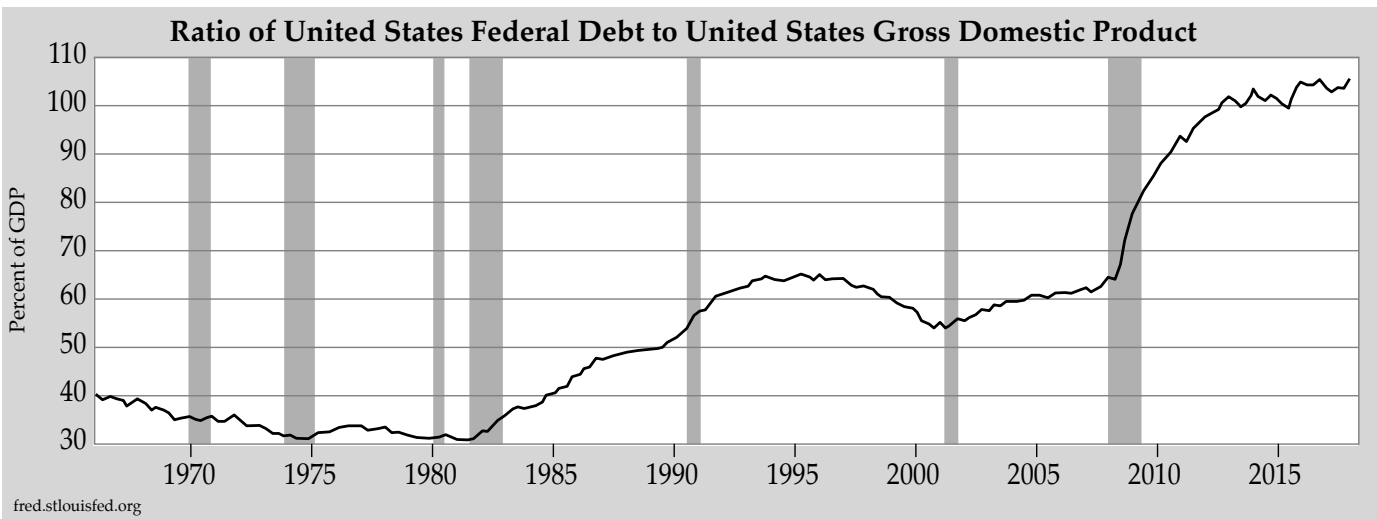
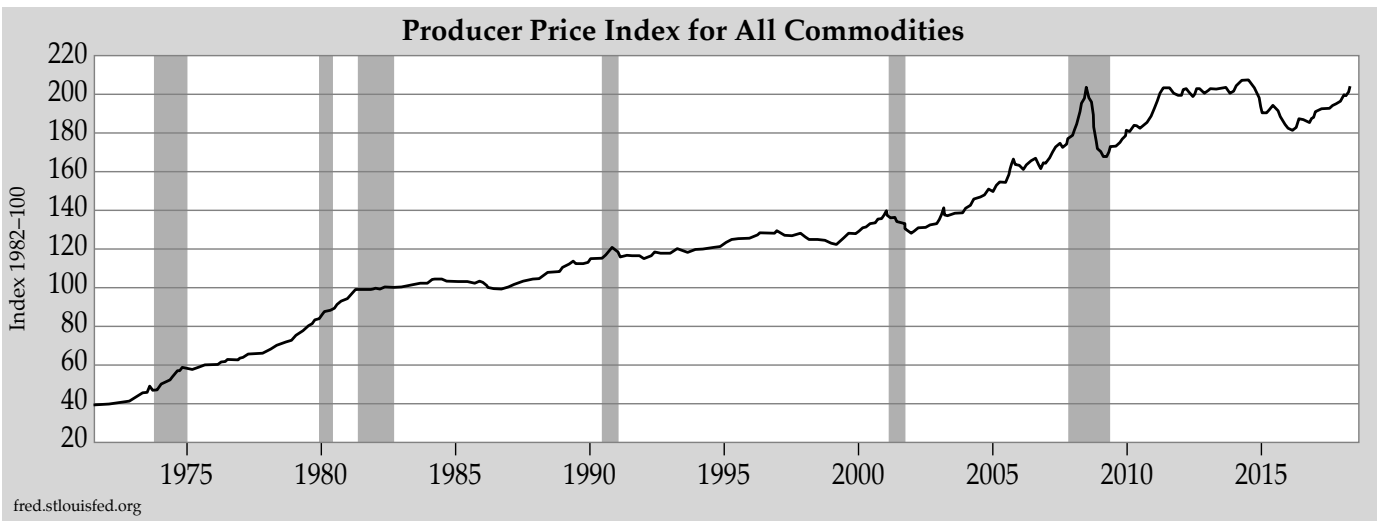
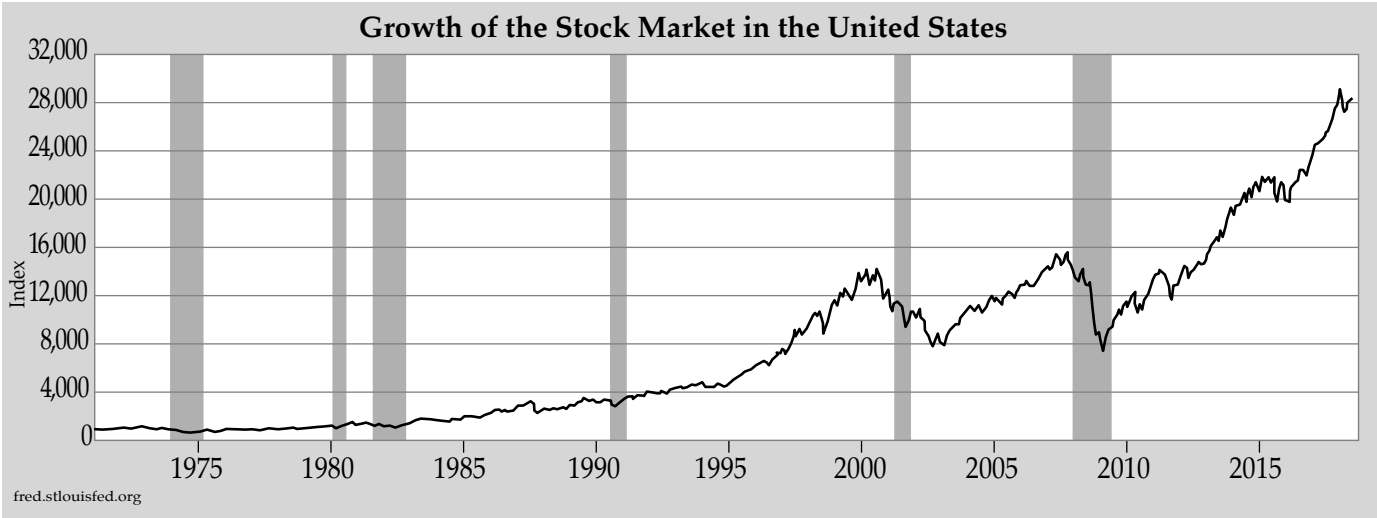


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Real Interest Rates in the United States [interest rates *minus* the rate of inflation]



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“But I don’t think he’d want to take us on in candy. [Berkshire owns See’s Candies.] And we’ve got some other businesses that wouldn’t be so easy. You can look at something like Garanimals [children’s underwear]. And it won’t be technology that takes away the business in Garanimals. Maybe something else catches the young kid’s fancy.”

“But there are some pretty good moats around. Being the low-cost producer [of a service or good], for example, is a terribly important moat. And something like GEICO, [new] technology really has not brought down the cost that much. Among big companies, we are a low-cost producer – and that is not bad when you’re selling an essential item.”

Then Buffett transitions from a business professor to a prize fighter, landing a job that nobody has ever directed at Buffett’s company: “People like his car. But somebody mentioned that now he’s talking about [needing additional] financing. There was something mentioned just this morning about that. That’s what I call a counter-revelation [laughs] because I think it was only a few days ago that they said Tesla wouldn’t need financing.”

[For our take on the serious challenges facing Tesla, see “Tesla’s Alternating Sentiment” from our April 2018 letter, <https://cheviotvalue.com/publications/investment-values/>, or request a copy and we will send it to you.]

PORTFOLIO UPDATE

Anheuser-Busch InBev traces its roots back to the 1852 founding in St. Louis, Missouri of the Anheuser-Busch Companies. That company merged in 2008 with the world’s largest brewer, InBev, a Belgian and Brazilian conglomerate, to form Anheuser-Busch InBev (“BUD”). Since that time, BUD acquired several large breweries, the largest being SABMiller in 2016. The company today sells across the globe several dozen household-name brands of beer, including Stella Artois, Modelo, Michelob Ultra, Corona, and, of course, Budweiser and Bud Light. BUD is approximately 50% owned by original founding Belgian families and the Brazilian investment firm 3G Capital.

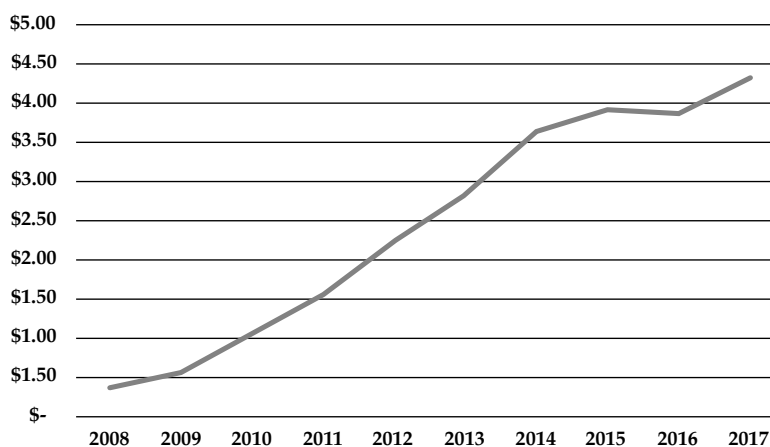
We expect the acquisition and integration of

SABMiller, with its strong presence in emerging market economies, to help fuel BUD’s growth during the next several years. As of last year, BUD began implementing SABMiller’s regional focus, something we expect to bear fruit. Furthermore, the company is emphasizing sales of higher-priced, “premium” beers which are growing fastest and earning higher than average margins for the company.

Potential for a slowdown in emerging markets where BUD has an increasing foothold, along with declining sales of Bud and Bud Light in the U.S., pushed down BUD shares. However, the company’s dominance in emerging and developing markets should be a strong long-term driver of growth for BUD. And we believe the stock market is too bearish on the problems BUD is having in this country, taking a “show-me” perspective with the newly-installed head of U.S. operations (who has an enviable track record with the company).

Having touched a high price of \$136 in 2015, BUD shares fell into the \$90s this past quarter. At the time of our purchase, the dividend yield was roughly 4.5% and we expect future payments to grow. We would welcome a lower share price and the opportunity to buy more shares at a level that we believe will produce attractive long-term returns.

Anheuser-Busch Inbev’s Growing Dividend



We also purchased shares of **Liberty Broadband** in the second quarter. Liberty’s main asset is a roughly 25% ownership interest in Charter Communications (operating under the name Spectrum), the second-largest cable and broadband provider in the U.S. Through its highly profitable broadband offering,

Charter provides a necessary service, producing growing free cash flows, supported by best-in-class management who have tremendous skin in the game. Legendary investor and cable pioneer John Malone controls Liberty and helps guide Charter.

Charter's growth in broadband customers and pricing power for fast internet service more than compensate for the decline in the company's cable subscriber base. Cord cutting is a growing consumer preference – as is watching more entertainment than in years past. And when they no longer have cable service, customers need a robust broadband offering. As such, broadband service increasingly resembles a utility in its growing essential need within the home, with better growth and equal or better pricing power than actual regulated utilities.

Charter's business is akin to a toll road on internet usage and growing adoption of "over the top" (i.e., "streaming") tv viewing. The company's broadband service is far more profitable than that of its cable product (there are no content costs for internet service).

Malone has a stellar history of shareholder-friendly behavior and results. He has stated that he will not sell Charter at a price below his view of fair value, a level that we believe is dramatically higher than the share price today. The company repurchased approximately 14% of its shares outstanding last year and is acquiring more this year, plowing large amounts of its free cash flow into what we think will be a rewarding investment.

CREDITS

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

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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.

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Liquidity:

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Affordability:

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We treat our clients in the way we would desire if our roles were reversed.

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