Cheviot Value Management, LLC

Investment Values

Celebrating 35 Years

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"Investing is most intelligent when it is most businesslike." - Benjamin Graham

These are "the nine most important words ever written about investing." - Warren Buffett

CONTENTS **Page**

Our Investment Outlook.................................... 1
How to Think About Stocks Now (And Forever)..... 3
The Allegory of Mr. Market, as Explained by Warren Buffett......................... 5
Credits and Disclosures...................................... 6

OUR INVESTMENT OUTLOOK

In finance, a black swan is an event that occurs which was both unexpected and something for which the majority of (if not nearly all) market participants were unprepared. The spread of Covid-19 from an obscure illness in Wuhan, China into a global pandemic is arguably the most extraordinary black swan in many generations.

In response to the sudden realization that the virus had taken root in the U.S. – and that domestic measures were slow to contain its spread – U.S. stock prices fell nearly 34% from their February high to their March low. Prices subsequently snapped back, regaining in just three days approximately half of what they lost, on the heels of a Federal Reserve ("the Fed") response that was unprecedented in size and speed. The U.S. Government also orchestrated a rescue package worth more than $2 trillion, something we expect to be the first of multiple fiscal stimulus packages in the months ahead.

In March, Treasury Secretary Steve Mnuchin said bluntly, "This is not the time to worry about the deficit." And, though it is quite possible the deficit for the year will exceed a heretofore unimaginable $4 trillion compared with last year's already steep deficit of more than $1 trillion, Mnuchin was right. There was no sensible alternative to enacting giant rescue packages for American citizens and businesses. There will be plenty of time in the future to analyze – and plan for – the effects of this gargantuan amount of deficit spending which laid bare U.S. finances positioned for blue skies, not a rainy day.

Contextualizing the size of the relief efforts was investment legend, Paul Tudor Jones, who stated on March 26th: "From a fiscal stance, we have a [rescue] package of 10% of GDP. That's double what we got in October of 2008 [during the Great Financial Crisis]. Now they came back in March [2009] with another package that got us up to 10% and my guess is they'll be back with a bigger fiscal package somewhere down the road. From a monetary standpoint, by the end of this week, [the Fed] will have purchased $1 trillion in government bonds and mortgage backed [securities]" to drive down interest rates and provide enough liquidity in the bond market. Right now, the Fed "did in two weeks what it took the Fed *eight months* to do in 2009… here we got a trillion dollars in *two weeks*. By May [of this year], at this rate, we will have already purchased what it took *six years* to do during the Great Financial Crisis. So investors can take heart that we've counteracted this existential shock with the greatest fiscal and monetary bazooka, it's not even a bazooka, it's more like a nuclear bomb. That's the countermeasure that we brought in to bring safety

Cheviot is in its 36th 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.

to our economic system… as Fed Chairman Powell said, this is the bridge to the future."

But will the Fed's bridge help the markets and economy safely cross the valley ahead?

The rapidity with which this virus caused a recession to begin in March is unmatched in history. Economists are predicting second quarter GDP to decline anywhere from -10% to -30%. (The disparity reflects the uniqueness of the current situation; in a typical quarter, economists may vary by as much as *one percent*.) Our expectations for the U.S. and global economy for the next 12-24 months encompass a wider range of potential outcomes than ever before. On one hand, a worst case projection includes a worldwide economic depression from which economies emerge in 18 to 36 months. On the other, a more optimistic scenario envisions widespread business activity inching closer to normal (some industries more than others, of course) no sooner than near the end of 2020 with economic growth resuming from there.

Stock prices fluctuate according to market participants' collective expectations of the future. When actual events beat expectations, buying exceeds selling and prices rise. Conversely, future events that disappoint market participants cause selling that weigh on market prices.

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- Paul Tudor Jones

The following factors could delay an economic recovery and prolong the bear market. An abbreviated list of negatives includes:

1. The virus spreads at a rate faster than currently feared (as of our writing this in the first days of April), more hospitals and healthcare providers become even more overwhelmed, and virus-related deaths rise to levels worse than expected.
2. Jobless claims and unemployment figures continue to rise higher or for longer than expected.
3. The healthcare industry fails to develop medicines in the nearer-term and vaccines in the more intermediate-term to combat the virus.
4. More companies outside of the travel and leisure industries become insolvent or declare bankruptcy.
5. Fiscal and monetary stimulus packages fail to sustain employers, employees, and other citizens throughout the remainder of the crisis.

In contrast, the following could be positive surprises for market participants which, in turn, may spur the market to rebound sooner rather than later:

1. Increased testing and known immunity help individuals contain the spread of the virus.
2. Data indicate that case counts are in decline and the worst of the pandemic is behind us.
3. Medicines are found to reduce symptoms of the virus and are capable of being produced in large quantities in the near term (numbers 1 and 3 paving the way for at least a partial re-opening of society).
4. Progress in vaccine development and eventual production indicates that there will be sufficient protection against the virus in the longer-term.
5. Fiscal and/or monetary stimulus proves sufficient to sustain businesses large and small, their employees, and non-employed citizens through the months and quarters ahead.

Given the quantity and complexity of each of these inputs, the current level of economic uncertainty is significant. As investors, we must remember that heightened uncertainty makes stock market participants more jittery than normal. A future that is so murky causes many in the market to express their uneasiness with periods of intense selling alternating with occasional bursts of manic buying. The brains of many market participants are overcome by their amygdalae – our mind's command and control center for the fight or flight response – causing individuals to vacillate been outright fear on one day and the fear of missing out on the next.

Controlling one's emotions, particularly in times of stress, can present the biggest challenge to

successful long-term investing. We do not yet know the duration of the impact from Covid-19, but we are reminded of the time-tested adage: "This too shall pass." And, before it does, we expect to acquire more attractively-priced shares of high-quality companies when the market presents them to us. The market volatility we saw in March – and may continue to see for quite some time – is in rarified territory. Volatility is best ignored or taken advantage of; conversely, it is not something to fear. We believe it will provide us with more bargain-buying opportunities to help plant the seeds of growth for years to come.

We hope the next two sections help provide examples of how to keep one's emotions from overriding the ability to remain rational in this unusually challenging environment. First is a brief summary of how we view stock ownership *at all times*. It is in part to this approach that we attribute our long-term success in navigating particularly volatile markets.

In our final section of this letter, we turn to the timeless wisdom of Ben Graham, successful investor and pioneering teacher of value investing. His most famous student, Warren Buffett, has prospered through numerous bear markets. Buffett recognizes stock market declines as not only inevitable but auspicious, for the intelligent investor may capitalize on such opportunities to buy stocks cheaply from others who are fearful. His re-telling of Graham's allegory of Mr. Market is a classic gem that may paint a helpful picture during this unique time for investors.

"We expect to acquire more attractively-priced shares of high-quality companies when the market presents them to us."

HOW TO THINK ABOUT STOCKS NOW (AND FOREVER)

If an investor is to passively own a business (that is, not participate in the management or ongoing financing of that business), there is essentially no long term difference to the owner if the entire business is owned versus only a portion. If what is owned is a portion, also known as a "share," then the investor is subject to one considerable difference that may be for that investor either an asset or a liability: the price of the share of the business, if publicly traded the way stocks are, is usually more volatile than the changes in value of the underlying business. During times of euphoria or great upheaval, stock price volatility can be so dramatic as to be completely unmoored from the underlying company's actual value. By contrast, such underlying value plods along much more quietly and to much less fanfare.

Intrinsic value, says Warren Buffett, is "an all-important concept that offers the only logical approach to evaluating the relative attractiveness of investments and businesses. Intrinsic value can be defined simply: it is the discounted value of the cash that can be taken out of the business during its remaining life."

"The calculation of intrinsic value, though, is not so simple. As our definition suggests, intrinsic value is an estimate rather than a precise figure, and it is additionally an estimate that must be changed if interest rates move or forecasts of future cash flows are revised. Two people looking at the same set of facts, moreover – and this would apply even to [Buffett's business partner] Charlie [Munger] and me – will almost inevitably come up with at least slightly different intrinsic value figures."

Now imagine that the two people setting the market prices are not as rational as Warren and Charlie. Instead, market prices are being set at the time by millions of market participants who are transacting under the duress of their own emotionalism. At times like we have seen since the outbreak of Covid-19, countless professional investors are buying or selling filled with the fear that they will be perceived as wrong over the coming quarter, month, week or even day. There are numerous other impulses driving investor behavior that are not strictly focused on rational, businesslike investing and a clear-minded calculation of the intrinsic value of the stock's underlying business. The result is market prices that are often quite different than the intrinsic value of the underlying company.

If determining the underlying intrinsic value of a business and comparing it to the market price of a stock was not challenging enough during nor-

mal times, it is certainly more complicated during social and economic crises. In the case of Covid-19, market participants sold shares overwhelmingly in an effort to preserve their capital ahead of what they feared would be lower future stock prices. During the first quarter, this caused stock prices in the U.S. to be lower by nearly 20% (after falling 34% from their peak). Some industries have seen their average share prices decline by more than 75% in just several weeks.

But, for U.S. businesses as a whole, or – more importantly to us at Cheviot – for the type of high-quality companies that we seek to own, have their long-term *intrinsic values* declined by a similar amount? If we start with the assumption that very high-quality businesses will survive the spread – and eventual containment – of Covid-19, then we must consider those future cash flows that Warren talks about when evaluating a company's true worth.

In the next five paragraphs we take a deeper dive into valuation scenarios. Please forgive us if you are not in the mood for a little extra math, and feel free to skip the next five paragraphs (we will not take it personally).

To understand the importance of a business's future cash flows, let us look at how different short-term earnings scenarios affect longer-term annualized returns to shareholders. Take the case of a company whose earnings were expected to be $2 per share this year. Before the Covid-19 outbreak, each share was trading for $40 apiece. This equates to a Price-to-Earnings ratio (P/E) of 20. ($40 ÷ $2 = 20.) Assuming annualized earnings growth of 6%, in 10 years' time this company's stock would sell at roughly $72 if it had the same P/E of 20. [($2 x $(1.06)^{10}$) x 20 = $71.63]

Now let's consider two scenarios in this post-Covid-19 world that we expect will prove overly cautious: one a very conservative outlook and another a worst-case projection.

In the conservative case, we assume the company has no earnings for two full years (2020 and 2021), and it is not until year three (2022) that the company resumes being profitable, but only at the level it was expected to be in 2020. (It is worth noting that, through the Great Depression, World War I and II, the Spanish Flu epidemic, and the Great Financial Crisis, the aggregate of large, publicly-traded U.S. companies has reported profits in *each* of the past 150 years.) To assume that our already-financially stable company would remain unprofitable for more than one year is a very conservative assumption.

In the worst-case projection, the company remains unprofitable for a period of *three* full years (2020, 2021, *and* 2022) and resumes profitability in year four (2023) at its 2020 level.

Under the conservative assumption, due to the change to our earnings schedule, after ten years instead of trading at nearly $72 per share, our company trades for $63.75 per share. In that case, the ten-year annualized return for our company drops from 6% per year to 4.77% per year. In the worst-case scenario our ten-year return drops to 3.32% year. Neither return is stellar, but even the worst-case is still far better than what can be earned in interest on a 10-year bond (less than 1% annually), CD, savings account or money market account. Importantly, neither scenario accounts for annual receipt of dividends, something that may boost returns *per year* by at least 2% to 3%. As such, total returns to post-Covid-19 buyers (of the right businesses) could be closer to a minimum of 7% to 9%.

The 20% share price decline occurring in the market in the wake of the Covid-19 bear market more than offsets the much smaller decline in the company's long-term intrinsic value. Moreover, the buyer of shares at that lower price stands to earn a satisfactory return by holding such a high-quality company for the longer term.

Temporary events can exact significant and even permanent damage on companies, particularly lower-quality ones. Investing in companies in the right industries with dominant market positions and strong balance sheets might be less glamorous than speculating in younger companies or loss-making enterprises that one hopes will someday act like a winning lottery ticket. But when times get tough, strong balance sheets matter a great deal. A corporation's ability to survive and eventually thrive through a downturn becomes paramount. In our portfolios, we try to hold businesses that can withstand severe economic difficulties and, in fact,

emerge even stronger from such challenges. High quality companies accomplish this by, among other things, gaining market share lost by weaker competitors or by acquiring those competitors outright.

Throughout Cheviot's history, we have strived to own durable businesses that can withstand economic turmoil the type we are now experiencing. We also have used major market downturns to increase our holdings of such businesses by acquiring shares when, to us, they represent a bargain price.

"Throughout Cheviot's history, we have strived to own durable businesses that can withstand economic turmoil the type we are now experiencing."

Buying shares of discounted companies is difficult now when the near-term future is so unknown as a result of a pandemic that is not merely a business event but a global shock that may threaten the health of our friends, our loved ones, and ourselves. As always, we rely on long-term projections of a company's intrinsic value. Despite the need for an analytical framework for how to view stock ownership, having the stomach to support the brain's attempt to act rationally is as important as ever.

THE ALLEGORY OF "MR. MARKET," AS EXPLAINED BY WARREN BUFFETT

Before purchasing any stock for our clients or ourselves (they are one and the same), we at Cheviot analyze the underlying business in an attempt to determine what that company will be worth over time. Once we ascribe a value to the company, we look to the stock market to see if we can purchase the company's shares for what we believe is below this value.

Conversely, market participants often look to the stock market for cues about what a company is worth. In our view, this process is incorrect. So, if the stock market does not determine the true value of a given company, what role should it play in investing?

In this closing section, we turn to an original idea of Ben Graham that was later summarized by his most famous student Warren Buffett, who describes his psychological framework for investing in the allegory of Mr. Market.

"Ben Graham, my friend and teacher, long ago described the mental attitude toward market fluctuations that I believe to be most conducive to investment success. He said that you should imagine market quotations as coming from a remarkably accommodating fellow named Mr. Market who is your partner in a private business. Without fail, Mr. Market appears daily and names a price at which he will either buy your interest or sell you his.

"Even though the business that the two of you own may have economic characteristics that are stable, Mr. Market's quotations will be anything but. For, sad to say, the poor fellow has incurable emotional problems. At times he feels euphoric and can see only the favorable factors affecting the business. When in that mood, he names a very high buy-sell price because he fears that you will snap up his interest and rob him of imminent gains. At other times he is depressed and can see nothing but trouble ahead for both the business and the world. On these occasions he will name a very low price, since he is terrified that you will unload your interest on him."

There are innumerable examples of both Mr. Market's overconfidence and his despondency throughout the years. Consider his outlook on the same company separated by less than three years' time. At the peak of his euphoria in 2000, Mr. Market was willing to buy shares of Cisco Systems for more than $80 each, valuing all of the shares at nearly $600 billion. That year, the company made approximately $3 billion in net income. This was a great deal for sellers who took advantage of his optimism. Just a couple of years later, Mr. Market was no longer feeling so sanguine about the prospects for Cisco nor his wide-eyed purchase from 2000. In 2002, at his most depressed, he was willing to sell you the entire stake (or an equivalent share) in Cisco for nearly $60 billion (90% less!) when the company was earning closer to $4 billion per year.

This is not to say that Mr. Market is *always* either euphoric or despondent. Often he is neither. But, as Buffett says, "Mr. Market has another endearing characteristic: He doesn't mind being ignored. If his quotation is uninteresting to you today, he will

be back with a new one tomorrow. Transactions are strictly at your option. Under these conditions, the more manic-depressive his behavior, the better for you."

Successful investors will remember that, "like Cinderella at the ball, you must heed one warning or everything will turn into pumpkins and mice: *Mr. Market is there to serve you, not to guide you.* It is his pocketbook, not his wisdom, that you will find useful. If he shows up some day in a particularly foolish mood, you are free to either ignore him or to take advantage of him, but it will be disastrous if you fall under his influence."

"Mr. Market is there to serve you, not to guide you."
- Warren Buffett

Investors who forget the role that Mr. Market plays and instead look to Mr. Market to value their companies, are bound to shoot themselves in the portfolio either by buying at too high a price or selling too low. It is vital to remember that Mr. Market's moods are his own, and they should not be used as a measure of the true value of the companies you own or wish to own.

"Following Ben's teachings, Charlie and I let our marketable equities tell us by their operating results – not by their daily, or even yearly, price quotations – whether our investments are successful. The market may ignore business success for a while, but eventually will confirm it. As Ben said: 'In the short run, the market is a voting machine but in the long run it is a weighing machine.' The speed at which a business's success is recognized, furthermore, is not that important as long as the company's intrinsic value is increasing at a satisfactory rate. In fact, delayed recognition can be an advantage: It may give us the chance to buy more of a good thing at a bargain price.

"Sometimes, of course, the market may judge a business to be more valuable than the underlying facts would indicate it is. In such a case, we will sell our holdings. Sometimes, also, we will sell a security that is fairly valued or even undervalued because we require funds for a still more undervalued investment or one we believe we understand better.

"We need to emphasize, however, that we do not sell holdings just because they have appreciated or because we have held them for a long time. (Of Wall Street maxims the most foolish may be 'You can't go broke taking a profit.') We are quite content to hold any security indefinitely, so long as the prospective return on equity capital of the underlying business is satisfactory, management is competent and honest, and the market does not overvalue the business.

"Our approach makes an active trading market useful, since it periodically presents us with mouth-watering opportunities… Eventually, our economic fate will be determined by the economic fate of the *business* we own."

Neither we at Cheviot nor anyone can know how the market will behave in the short run. As described earlier in Our Investment Outlook, the possible outcomes for the impact of Covid-19 on society and the economy are far too wide and unknowable at this time. At Cheviot, we are paying attention to virus-related developments as we continue to focus on the businesses we own and those we would like to own. Mr. Market may well provide us with intelligent investment opportunities in the period ahead.

CREDITS

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

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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