CHEVIOT VALUE MANAGEMENT, LLC

INVESTMENT VALUES

Issue Number 107, July 2013

"Everything you want to know about the future is right there – in black and white – in the history books." – Frank Giustra, financier

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OUR INVESTMENT OUTLOOK

The second quarter of 2013 was anything but a dull three months. We witnessed an improbable and most unusual drop in the price of gold, a massive run-up and subsequent decline for Japanese stocks, a Chinese stock market that flirted with bear market territory, and wildly fluctuating emerging markets. Bonds, those supposedly safe and sleepy investments, violently awoke their investors as prices fell more than 10% in mere weeks. All the while, a growing number of market participants became increasingly enamored of U.S. stocks just before they, too, hit a rough patch.

Yet before this turbulence arrived, one could almost hear a chorus of market participants chanting, "investing is easy." CNBC cheered the market rally which lured more individual investors back into stocks. The CEO of TD Ameritrade recently had this to say about brokerage account holders of his firm (*i.e.*, the average market participant): "We are seeing more buying today than we have in a long time." Simultaneously, he noted that clients were selling metals-related holdings. Rising stock prices caused individuals to buy aggressively at a time when share prices were approaching all-time highs and to sell what we believe is the cheapest sector of the market. History may be on the verge of repeating.[1]

Just as the lay investor found investing to be no challenge at all, some of the most sophisticated investors found the climate downright hostile. Ray Dalio's firm, Bridgewater, is the world's largest hedge fund operator. Former Federal Reserve ("Fed") Chairman Paul Volcker has said that Bridgewater does better research and analysis than the Fed. When a fund so intelligently managed as Bridgewater can see its largest fund fall 8% thus far in 2013, or when Seth Klarman, the eminently successful value investor says that this might be the toughest investment environment of his 30+ year career, it might behoove the average market participant to tone down his or her optimism.

In the meantime, the investment community's animal spirits are alive and well as are their potentially ominous byproducts. Margin debt borrowed against investment accounts recently reached an all-time high. Previous records coincided with stock market peaks in early 2000 and summer 2007. And those peaks were followed by major declines (see graph on page two). As a percentage of the overall economy, margin debt is now almost 170% greater than it was on the eve of the stock market crash in October 1987. One reason why high levels of margin debt make for a potentially dangerous environment is that the borrowed money which funded stock purchases will need to be repaid quickly should there be a significant decline in share prices. Selling stocks to meet margin requirements or pay back loans could easily compound the decline.

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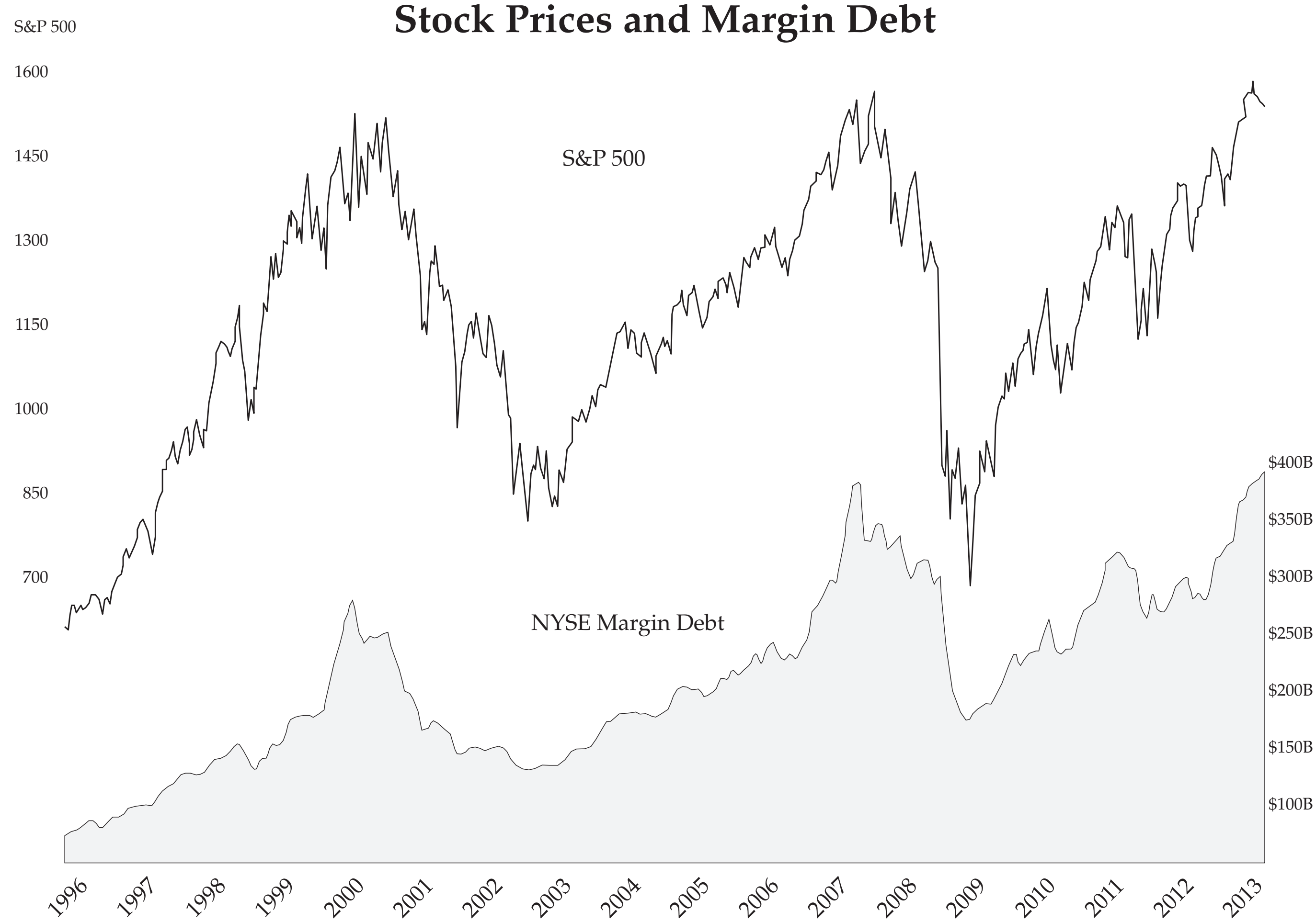
Stock Prices and Margin Debt



With U.S. property prices levitating in large part due to low interest rates and bank-suppressed inventory, investors are commonly turning to margin debt from their stock portfolios, not just to purchase more stocks but, to fund speculative purchases of real estate. This high-wire act should only be performed by the most sophisticated investors, those knowledgeable of the risks involved. Borrowing against one's stocks to buy real estate shows, in this case, that history rhymes. For it was in the stock market mania of the late 1990s when individuals regularly turned to their home mortgage as a source of funds for buying into the most overpriced stock market ever.

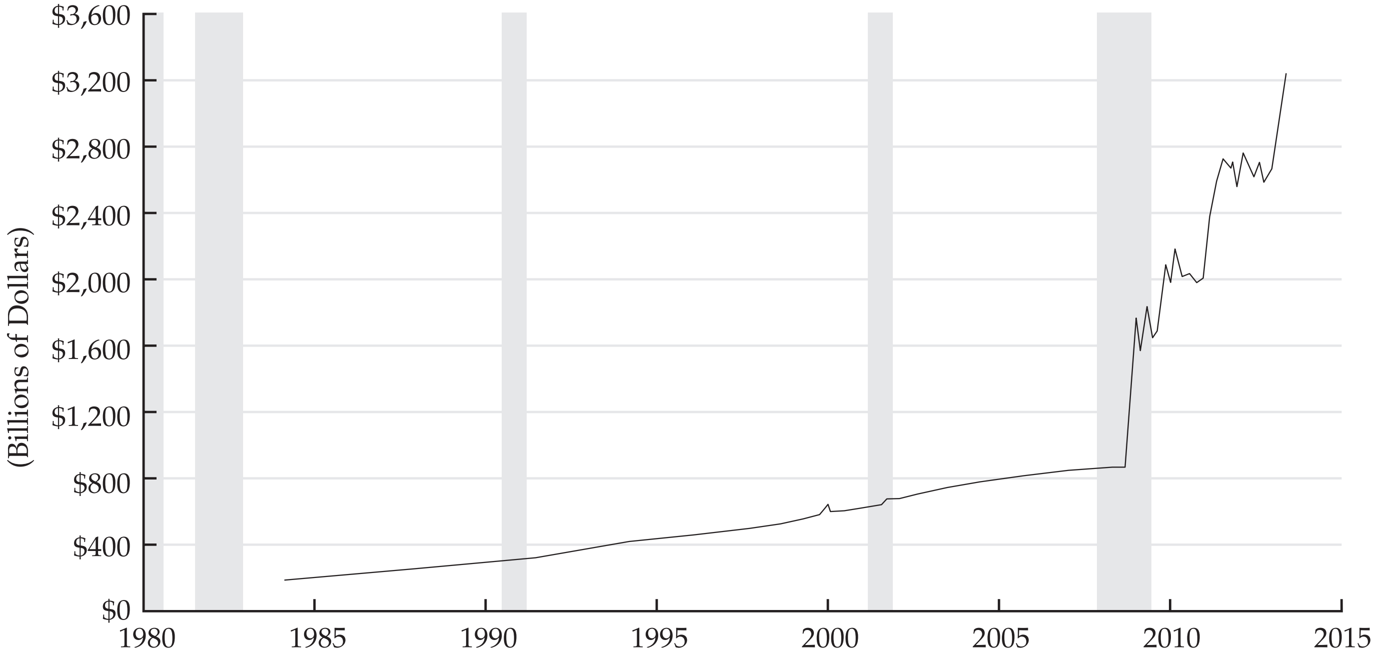
Today's stock prices are not as elevated as they were then, but they are high enough to prevent an abundance of bargains for the value-minded investor. Fortunately, financial markets, in their cyclical nature, always find a way to push prices higher and lower in relatively short order. We keep our eyes fixed for chances to wisely buy and sell the opportunities created by these moves.

Is the Fed trapped?

In response to the 2008 economic crisis, the Fed quickly lowered interest rates to zero and then stimulated further by purchasing (thus far) $2.5 trillion of available mortgage securities and U.S. debt (known as ''quantitative easing'' or ''QE''). This rescue effort is aimed at keeping interest rates low and increasing the solvency of large banks. The scope of this stimulus is unprecedented in U.S. history.

While the Fed has not waivered from its zero interest rate policy since 2008, it has varied the pace of purchases under its QE programs, increasing stimulus, decreasing stimulus, stopping stimulus, and restarting it all over again. Each time there was a pause in Fed purchases, the stock market declined significantly, and before too long, the Fed

U.S. Monetary Base to June 2013



Shaded areas indicate U.S. recessions

Source: Federal Reserve Bank of St. Louis

resumed its stimulus, relieving the markets and sending them higher. By now, the Fed has made an addict out of the markets. Says monetary policy historian, James Grant: ''You can't just do a little QE. You are stuck, you must keep on doing it and doing it and doing it.''[2]

By increasing stimulus when needed, the Fed has a history of being friendly toward the markets and banking industry. Recall the Y2K fears of banks ceasing to function properly in response to a software bug not recognizing the new year. To prevent feared financial fallout, the Fed provided roughly $35 billion of additional liquidity to banks in the final months of 1999. (Please see the tiny bump above the year 2000 in the above graph. You may need a magnifying glass but please do not hold it over the page for too long. That is because the monetary base is the kindling for the fire of potential future inflation. Once banks start lending more actively and money changes hands more quickly, the smoldering could begin.)

The $35 billion that Alan Greenspan used to support the banks in 1999 helped push already inflated stock prices even higher. After Y2K arrived without the feared banking consequences, the Fed was free to withdraw this injection of liquidity. If stock prices were in a bubble, the withdrawal of liquidity may have been the pin. From the first quarter of 2000 through the end of 2002, the S&P 500 plummeted nearly 40%.

Since 2008, the Fed has stimulated by more than *70 times* the amount of late 1999. It is now stimulating at the pace of a Y2K injection every 12 days. So dependent is the market on monetary stimulus that it declines every time the Fed does so little as talk about reducing the pace at which it adds stimulus, never mind suspending stimulus or withdrawing it altogether. Surely the Fed knows that weakness in the economy has prevented it from ceasing stimulus. It must at this time know that there is no way for it to actually withdraw the $2.5 trillion worth of injections without crashing the markets and economy. As a result, this money will remain available for banks to use when and as they see fit.

So far in 2013, the Fed purchased nearly 80%, a staggering sum, of all bonds issued by the U.S. Government. This demand for bonds kept prices high and yields low, but recent talk of a reduced rate of Fed purchases crushed bond prices and sent interest rates soaring. 30-year fixed mortgage rates quickly climbed from 3.5% to more than 4.5%. This counteracts the Fed's goal of increasing housing prices through low interest rates. Without a way to increase employment directly, the Fed has wished upon the "wealth effect" whereby it hopes that higher housing prices will make consumers feel wealthier, thus encouraging them to spend more. Rising rates may extinguish this hope.

The accompanying table shows what happens to a potential homebuyer's monthly mortgage payment given an increase from a 3.5% mortgage rate on an initial $500,000 loan fixed and amortized over 30 years. Also see how much the price of the home would need to fall for the monthly mortgage to remain the same given the indicated increase in mortgage rates.

Mortgage Rate	Monthly Payment on a $500,000 Mortgage	$ Increase in Monthly Mortgage Payment	% Increase in Monthly Mortgage Payment	% Decrease in Price of House
3.5%	$2245	0	0	0
4.5%	$2533	$288	13%	-11%
5.5%	$2839	$594	26%	-21%
6.5%	$3160	$915	41%	-29%
7.5%	$3496	$1251	56%	-36%

With this in mind, we ask: How can the Fed possibly allow interest rates to increase? Or, said differently, we expect the Fed to do all within its power to suppress rising rates. Higher borrowing costs are already hampering the housing market. Housing and housing-related commerce is a *major* driver of economic activity. It comprised nearly *70%* of the first quarter's anemic GDP growth. A reduction in housing demand would most certainly restrain economic growth. Simply put, the Fed must fuel the housing market with low interest rates; otherwise, the U.S. economy will suffer.

Says interest rate expert and "bond king" Bill Gross: "We're in a highly levered economy where households can't afford to pay much more in interest expense. Monthly payments for a 30-year mortgage have jumped 20% to 25% since January. Mortgage originations have plummeted by 39% since early May. High levels of leverage, both here and abroad, have made the global economy far more sensitive to interest rates… If the Fed were to hike rates or taper [stimulus] suddenly, the economy couldn't handle it. [Bernanke] badly wants to avoid the mistake of premature tightening [raising of interest rates], as occurred disastrously in the 1930s."

Today, the market maintains faith in the Fed's abilities to see and steer our economy. Yet this is the same Fed whose loose monetary policies caused the housing bubble and subsequent financial calamities. Moreover, for many years now the Fed has been optimistic but wrong about the economy. Recall just this smattering of absolutely egregious errors of wishful thinking:

- 2006: Home prices will keep rising;
- 2007: The subprime mortgage disaster will not spread nor harm the banks or economy;
- 2008: Fear not the financial footing of Fannie Mae and Freddie Mac;
- 2008: The economy is not headed toward recession;
- 2009: The Fed will not monetize U.S. debt.

Following the greatest economic decline since the Great Depression – that which the Fed did not see coming – the Fed has consistently been wrong about its ability to end or withdraw its stimulus program. It overreached on expectations for economic growth in 2010, 2011, 2012, and again so far this year. The Fed talked in late June about "tapering" its stimulus in part due to expected economic growth in the first quarter of this year. The Fed expected growth of 2.4%. Actual growth was revealed to be 1.8%, another huge Fed miscalculation. It is being "far too optimistic," says Gross. He calls their expectations of 7% unemployment by the middle of 2014 "a long shot."

Yet the market continues to believe that the Fed will, for the first time, actually end its monetary policy and – confounding as it may be – do so with neither negative nor unforeseen ramifications. The market today may be forgetting that the economy is reliant upon artificially low interest rates. Few market participants care to remember right now that the Fed quickly reverts to more stimulus whenever the markets or economy slump.

Bond investor Jeffrey Gundlach reminds the market: "If we slow down quantitative easing, don't take it as a sign that it won't come back again. If interest rates are going to rise, it means quantitative easing was a total failure. It means the budget deficit of the U.S. is going to explode into a massive crisis. It means housing is going to crash, because it is interest rate based."

QE, he continues, "is not a solution. This is a temporary way of keeping things together, while somehow hoping that global growth appears, but that's not going to happen. What you've got is this policy that's very short-sighted and will have immense long-term consequences. It will spiral out of control."

So the Fed is faced with a dilemma. It can end its stimulus programs which could easily cause a significant near-term economic crisis; or it can continue to monetize the majority of newly-issued U.S. debt, keep interest rates extremely low, and face longer-term inflationary problems. Our modern day Fed avoids short-term pain at all costs, suggesting to us that the Fed's policy of QE will continue longer than the market currently expects. In our view, leaving a future mess for his successor will be the only "exit strategy" Chairman Ben Bernanke employs.

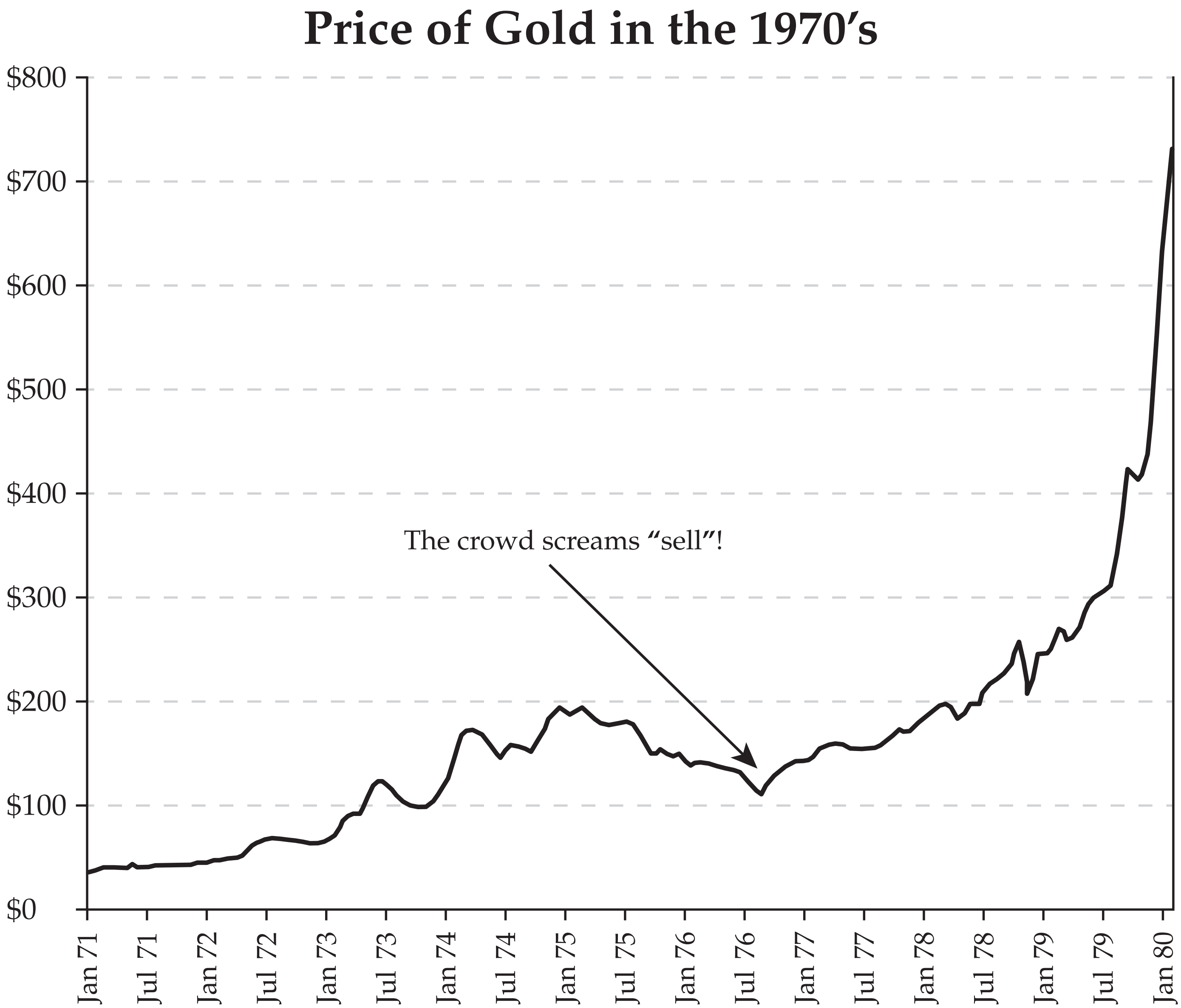
CERTAINLY NO TIN CAN

Historically the price of gold is more likely to rise when the market anticipates increased inflation and is more likely to decrease when the market expects deflation. Many attribute this year's lower price for gold to selling caused by fears that the Fed will permanently end its stimulus thus risking deflation more than inflation. To us, it is unlikely that the Fed will end its easy money policy in the foreseeable future, especially given the shaky footing on which rest today's elevated stock and housing markets. Upon the mere mention of a reduction in stimulus, financial markets fell and housing affordability dove in response to higher mortgage rates. Consider the apple cart upset.

This quarter's gold price decline has been met with immense worldwide demand for the physical metal (contrasted with the "paper" version of gold being sold on exchanges), especially in Asia. (Such was also the case in 2008, when deflationary fears sent the gold price down by more than 30%, creating a wonderful buying opportunity). Worldwide demand reduced the supply of available bullion causing individuals to pay high premiums over the market quoted price. In our view, much of the record-setting quantities of recently acquired physical gold will likely not become available for sale again for quite some time. We view this as supply that may have been permanently taken away. This could be particularly true in China where gold stockpiles are growing as a way to diversify away from their holdings of U.S. Treasuries. Furthermore, we should not be surprised if the People's Republic is also strategically planning for ways to dethrone the U.S. dollar as the world's reserve currency.

While other parts of the world are bullish on precious metals, many in the U.S. are not. But in September 2012 – *when gold was priced higher* – Wall Street sentiment toward gold was bullish, with targets of $2,500 and $3,000 per ounce. Now, as it did *after* the decline in 2008, Wall Street is once again downgrading precious metals. This is reminiscent of numerous bear markets throughout history that were met with brokerage recommendations advising their clients to sell. We believe that today Wall Street is piling on at the wrong time as it has repeatedly in years past.

When an asset class declines in price, usually the loudest market response is the contingency which decries its value and forecasts a continued swoon. Gold, as an asset class, is obviously not immune to this call. Says the *New York Times*: "The most recent advisory from a leading Wall Street firm suggests that the price will continue to drift downward, and may ultimately settle 40% below current levels... The sharply reduced rates of inflation combined with resurgence of other, more economically productive investments, such as stocks, real estate, and bank savings have combined to eliminate gold's allure." The *New York Times* stated this on



August 29, 1976. It had no way of knowing at the time that the bear market in the price of gold ended four days earlier.

Past behavior of financial markets may provide clues to future behavior. Just as the stock market declined mightily from 2007 into 2009 (by more than 50%), the stock market fell by nearly the same amount in 1973 and 1974. In both cases stimulative Fed policy quickly followed and share prices recovered their ground (taking three years for the 1974 bear market and five years for the 2008 debacle). In 1976, once the market recovered, the ruling consensus of the day was that all was well again (and interest in gold swooned). The consensus was wrong. The belief that all is well today is also now the majority opinion.

Time Magazine from August 2, 1976 ran a piece titled, "The Great Gold Bust." This story referred to gold as having "as much luster as a rusty tin can" and stated, "The economic conditions that triggered the gold boom of 1973-1974 have largely disappeared." Fed Chairman Arthur Burns was proclaimed a hero for orchestrating a comeback without the side effects of inflation. (This should remind you of the current opinion of the Fed.) Readers of *Time* could not have received worse advice. The price of gold reached its low within days of this widely read article. The gold price then marched higher by more than ***700%*** over the ensuing four years. Gold mining stocks performed extraordinarily well.

The graph on page six depicts the price of gold throughout the entire decade of the 1970s. The tortuous bear market of 1976, similar to that which we are experiencing today, appears as a mere pothole on the highway to dramatically higher prices.

Investors in 1976 and 2008 who were able to withstand the deluge of misinformation and hold on or buy more precious metals investments were eventually glad they did. These investors recognized then, like today, that monetary policy was a friend of the price of gold. Today the Fed can only talk about reducing the pace at which it continues to increase the monetary base. There is no discussion at all of reversing the monetary stimulus which has been put into the economy. This is where so many investors today get it wrong when they compare gold's price now to the fallout from the high price for gold in 1980. Then, the Fed was restricting the money supply and raising interest rates dramatically in an effort to thwart inflation. Today's Fed is stimulating by tremendous sums, keeping interest rates at zero, with the goal of *increasing* the rate of inflation.

Bernanke is today considered to have orchestrated a maneuver whereby a great depression was averted, stock prices were returned to pre-crisis highs, real estate is levitating again, inflation is not to be feared, and the Fed can withdraw its unprecedented stimulus without sending the fragile economy into a tailspin. "Folks, if you believe this fairy tale," says extraordinary investor Fred Hickey, "then you are not unlike the poor dupes who panicked and sold all their gold right at the bottom in the 1976 gold capitulation." Hickey continues: "Here's the difference between now and the 1970s: Burns' easy money policies were minor league stuff compared to what the Fed, Bank of Japan, Bank of England, Swiss National Bank, and others are doing today. The inflation risks today are orders of magnitude greater than in the 1970s, when there was no quantitative easing, no quadrupling of balance sheets, and no trillions of high-powered reserves printed out of thin air."

Supply Shortages May Cause Higher Prices

While money can be printed, gold cannot. In response to fears that its gold might not be where it thinks it is – or in the quantity it expects – Germany earlier this year requested a withdrawal of some of its gold from various global storehouses. With more than 1,500 tons of gold held in a vault at the Federal Reserve branch in lower Manhattan, Germany's request of 300 tons should have been easily granted. Not so. Germany will need to wait *seven years* before receiving all 300 tons that it requested. While the U.S. says it will eventually return the small portion of Germany's gold that it demanded, the largest Dutch bank, ABN Amro, told its clients that all requests for their gold will instead be paid in cash. For years, people in the gold community have pondered whether there is as much gold available as statistics show or if there is an unknown shortage. The above examples are just two which lend credence to the latter.

The lower recent gold price will reduce global gold production as new projects and less economic ones are shuttered. Market perception regarding this potential reduction in supply may help support the price of gold. Moreover, the market's recognition that there may be a major shortage of gold would likely cause a sea change in today's dismal sentiment for gold.

Currently, nearly every index that measures investor attitudes toward gold is at an extreme if not all-time low. One measure indicates that bullishness is squarely at 0%. The gold market now represents fertile ground for the contrarian investor to cultivate.

Contrarian investors often focus on the errors in pricing that markets create when sentiment is carried too far. Currently, valuations for gold mining companies are at remarkable low levels. Based on price-to-cash flow, the shares of large gold mining companies have in previous years traded within a range of 6 to 26. Today's level is 6. Similarly, price to book value (a measure of the market price against the net worth of a company) has ranged

Price to Book Value for Large Gold Companies

between 3.6 and its 2008 low of 1.0. Today's level is 0.91, below that of the 2008 global selloff. (See above graph.) At today's prices, an investor could buy all of the shares and debt of the largest gold mining companies, liquidate the businesses, and make a considerable return on their investment. Because of this more than theoretical option, levels such as these have often provided a floor under a bargain share price. Such valuations are rare and have historically attracted interest on the part of investors. In this way, low valuations can result in higher prices. When there is intrinsic underlying value, good things usually happen to cheap stocks.

Dividend yields for today's large gold mining companies are substantial. Many mining companies offer income levels greater than those of long-term bonds. It is no wonder that gold company insiders are buying back shares. Says Ted Dixon, expert on insider transactions: "Such a high level of buying interest among officers and directors within their own businesses in the resource sector has correctly foreshadowed a recovery in share prices in the past." The last time such a level of insider buying existed was during the opportunity-rich 2008 meltdown.

Valuations and insider behavior may speak volumes to us, but they are no match for human nature. This is because human emotions are usually in perpetual battle with investment prices. High prices make us feel good and trigger us to want to buy more. Low prices the opposite. While people flock to sales for discounted goods and services, they typically run from cheaper prices of investable assets. Just as lower prices darken sentiment, it is too often overlooked that lower prices also set the stage for positive future performance. Moreover, lower prices increase the chances that future returns will be greater than currently expected.

When any asset class falls out of favor on Wall Street, it usually becomes priced so low that it makes little sense to sell and much sense to hold (or buy more), awaiting the turn in sentiment. ***Keep that which is cheap.*** After a decline, studies show that industry groups tend to rise dramatically over the ensuing three years. Since the 1920s, a 60% decline in an industry has resulted in a rise of 71% within 36 months. Furthermore, any time the gold mining industry has performed as it has in the last 18 months, future returns are substantial.

There are six previous periods in which gold mining companies have similarly underperformed relative to the general stock market. The average return following such periods is a *gain of 221%* in little more than one and a half years.

This is because bear markets give rise to bull markets. The nature of the recent decline, coupled with what we see as fundamental support underlying the precious metals, causes us to believe that we could see explosive positive performance from our gold-related investments.

When gold mining shares performed like this previously, their average gain over the next year and a half was +221%.

Contrarian and value investor Marc Faber agrees: "Gold shares are extremely depressed," he said in June. "I think there is an opportunity for a relatively sharp rebound in gold shares." Faber correctly witnessed and avoided bubbles during the last couple of decades by capitalizing on opportunities for safe investment in beaten down industries and markets. He is not alone among a small group of investors who safely navigated their way through major market surges and meltdowns of recent history. We closely study these investors whose wisdom rings far truer to us than the opinions of others who cannot boast similarly successful long term investment performance.

One such successful investor, Bill Fleckenstein, does not mince words: "The smart money is set up [invested] one way and the so-called dumb money is set up differently. The people that have been pretty good at understanding the difficult environment we've been in for the last 15 years all tend to be bullish on gold and the ones who never understood any of it all tend to be bearish. What do you want to do? It's pretty simple as to what side you want to be on."

The Fed today continues on a path that we recognized beginning in the late 1990s. We then saw an overpriced stock market that, when it eventually burst, would cause the Fed to over-stimulate. That overly aggressive response to deflation fears would spur a bubble elsewhere in the economy (housing) whose eventual demise would spur tremendous action on the part of not just the Fed but central banks throughout the world. The debts accumulated throughout this process would require many years of stimulus, including monetary expansion, which would eventually stoke fears of inflation. We believe that we remain headed down this path.

Easily within the next couple of years we expect there to be a smarter and better time to sell precious metals holdings. By that we mean when prices are higher and when the market, abiding by its cyclical nature, favors gold-related holdings once more.

Jim Rogers, a member of the "smart money" investors, says he'll sell his precious metals "when there's a bubble in gold." Though he does not know when this will be – timing is unknowable in investing – he continues, "We haven't seen a bubble yet." While today many Americans are selling their gold, as evidenced by the number of dealers and stores buying from individuals, "Later, there will be signs that are saying, 'We Sell Gold,' and people will be lining up to buy it in big ways. That hasn't happened yet."

We will likely not wait that long to begin selling our gold-related positions. Just as we did with other investments that we bought and held through tough periods, we will probably sell early. Sentiment always turns and we expect it will here again.

In financial markets, history repeats itself because human nature does not change. In our opinion, history barely needs to rhyme for the precious metals to perform extraordinarily well going forward.

MISINFORMATION MANIA

The current sentiment toward gold has rarely been this negative. People who missed gold's rise during much of the past decade (and, notably, who also missed other major financial events of the recent past) have lately been quite vocal with their opinions. Couple this with a healthy dose of uninformed and sloppy mainstream media coverage of the gold market and you get a barrage of nonsensical articles casting a poor light on precious metals.

One of the many flagrant examples relates to the investment decisions of legendary investor George Soros. This past quarter it was widely reported that Soros had gotten out of gold. "Soros Dumps Gold" and "Soros Sells Gold, Should You?" were two such headlines. CNBC went so far as to broadcast that Soros sold 530,000 shares of SPDR Gold Shares ("GLD"), the popular gold exchange-traded fund ("ETF"). Soros' supposed sales were big news.

We now interrupt this broadcast with a few facts. From his pile of 600,000 shares of GLD, Soros sold 69,100 (or approximately $10 million worth). At the same time he purchased $40 million worth of shares of a basket of gold mining stocks (the Market Vectors Gold Miners ETF, "GDX") and $25 million worth of bullish call options on the junior mining version of the same (the Market Vectors Junior Gold Miners ETF, "GDXJ"). These transactions increased his effective holdings of GDX and GDXJ by 75% and 53%, respectively. They also resulted in Soros expanding his overall gold positions by $60 million. As of the end of the quarter, Soros' stake of gold-related investments had risen to nearly $240 million.

Says Canadian billionaire financier Frank Giustra: "There's more information being thrown at you than any other time in history but the quality of that information is really poor. I think the mainstream media is doing a great disservice to the average investor in many different ways. For the average investor that's out there just trying to make an honest buck by putting some money in the market or in bonds, the information is just terrible."

SPEAKING OF FRANK GIUSTRA...

Today, access to information is greater than ever but is the information more helpful? We often hear and read news and "analysis" that is spurious at best. In times like these, it may be wise to turn down this "noise" and focus on what successful investors think.

One such investor is Frank Giustra (first syllable rhymes with "juice"). He is a successful financier in a variety of industries. In 2007, he pledged more than $100 million to various causes in addition to half of all of his future earnings. In addition to philanthropy, Giusta spends considerable time mentoring youth.

While he rarely speaks publicly, two lengthy interviews of him from the past year are available online as is an interview with Canada's *Globe and Mail*.[3] Giustra spoke frankly about the financial landscape and his plans for navigating it.

The words used by our Fed are very important, he says. But they are misleading. "'Quantitative easing.' It sounds very calming and sophisticated. *It's money printing.* The reason they don't call it 'money printing' is because it's less alarming to say 'quantitative easing.' It sounds like a normal thing to do. It's okay because it has an elegant sound to it."

Lack of fear of quantitative easing plus a sluggish economy are keeping inflation at bay – for now. "You haven't seen inflation yet because the velocity of money is at a complete standstill. The velocity of money is the speed at which money changes hands. And that's created by spending, investing, borrowing, lending, etc. That's ground to a halt. It hasn't been this slow since they started keeping records back in 1959. What we have seen through the easy money policies of the last 15 to 20 years are asset bubbles. So you're seeing monetary inflation manifest itself into asset bubbles. The last one was the crash in 2008 caused by the real estate bubble."

Actual inflation is a real concern for Giustra. "We're already witnessing inflation – it's just not reported." For example, "When you go to the gas pump, or the grocery store, or you pay tuition or healthcare or insurance, do you really think inflation is running at 2%? It's not. But that's what they're leading you to believe."

"We haven't seen inflation in the classic sense but you have seen inflation in the form of asset bubbles. If you look at the S&P [500 index] right now, I think that is partially an asset bubble caused by easy money. It's easy money that is driving the S&P to all-time highs, not actual economic conditions or earnings."

As you might expect, Giustra views the financial markets with an abundance of caution. "I'm really careful with the markets right now. I'm just wondering where all of the earnings growth is going to come from to fuel higher prices. I'm really suspect on that."

Is he bothered by the recent decline in the price of gold? No. He calls it a "correction and a pretty severe one, but not unheard of." He reminds us (as we write elsewhere in this letter) that the price of gold fell by more than 40% in the mid-1970s before rising to dramatically higher levels. Giustra finds tremendous value in financial history.

And he is unshaken in his thesis for owning gold. "Nothing has changed on the fundamental side. The behavior that caused this gold market [to go higher] in the first place is just intensifying with all this money printing that's going on around the world now."

The billionaire is positioning himself accordingly: "I'm really focused on trying to find bargains, things that are really washed out, that are completely out of favor. In every market cycle you get these things that you wouldn't want to touch with a ten foot pole. Those are the ones you've got to buy. And then all you need is patience."

Opining that the bull market in gold is not over, Giustra said recently that he finds the largest gold mining companies to be attractive. After all, they appear to be extremely cheap.

"If I were an investor out there I would really start to think about the fact that this will change. Look at value and buy it. Pick right and sit tight. You will make a lot of money *eventually.* But you might need to have a lot of patience. There are some tremendous opportunities out there."

What does an investor of Giustra's caliber do when his holdings decline in price? "Take a deep breath. Either average down [buy more at a lower price] or sit tight. At the very least, sit tight."

Remember, "When the velocity of money starts to kick in, that's when you're going to really see all of this money, these trillions and trillions of dollars, going into things. And the favorites are commodities, gold and other real things."

When inflation comes, "It's the beginning of the end for the US dollar. I don't want to sound apocalyptic, but how else does this end? You have to be on the right side of this trade."

Do not believe for a minute that Giustra is a "gold bug" who likes gold in all environments. In fact, he looks forward to when he can sell it. "Absolutely. Gold is the single biggest asset in my portfolio because I believe it is going a lot higher. But there will be a time to sell it… I will know when it is time to sell by the way it is behaving and by what is going on at that time."

What will he be looking for? "It's going to have a parabolic spike, caused by some event or some loss of confidence – a U.S. dollar crisis would be a perfect example. That will cause gold to go through the roof, and then everybody will want to own it. And that's when you'll want to sell it."

MARKET PSYCHOLOGY AND INFLATION

Inflation refers to rising prices of goods and services in an economy. Typically, inflation is caused either by an increase in aggregate demand for goods or services relative to existing supply or a decrease in the value of currency in circulation due to monetary expansion or some combination of the two. Think of it as too much money chasing too few goods. Deflation refers to a general decline in prices of goods and services due either to greater efficiencies in supplying said goods and services (a healthy form of lower prices), a decline in demand for goods, a reduction in the supply of money or credit, a decrease in personal, government, or investment spending, or any combination thereof.

Severe inflation or deflation can have negative effects on an economy including dramatically increased or decreased prices of goods and services, rising unemployment, and severe economic contraction. The Fed attempts to avoid both high inflation and any amount of deflation either by lowering interest rates to stimulate a sluggish economy or by raising interest rates to cool an overheated one. In general, the Fed manipulates interest rates primarily by raising or lowering short-term interest rates by decree, buying or selling bonds issued from the U.S. Treasury ("quantitative easing"), or by raising or lowering bank reserve requirements. Lower interest rates and lower bank reserve requirements introduce new money into the economy; higher interest rates and higher bank reserve requirements remove money from it.

The effects of inflation are not typically felt until the newly-introduced money finds its way into general circulation. The rate at which money changes hands in a given period of time is known as the velocity of money. The faster and more frequent the hand-offs, the more goods and services are bought and sold, and the more robustly an economy expands. If money does not change hands, then an increased supply of money has little direct effect. That is, if the money only sits in the coffers of banks as reserves, there may be little or no inflation in the general economy.

Banks today hold record levels of reserves, but after their near-death experience ushered in by the 2008 housing crash, they have chosen not to lend them as aggressively as in prior periods. These reserves are in large part the product of the Fed's ongoing quantitative easing program. The Fed would like to see increased lending and higher inflation from today's levels. While these reserves lay somewhat dormant, financial markets do not currently fear future inflation.

There is a very instructive time from our financial past, however, when the Fed focused all its efforts toward squashing inflation. Yet, at that time, financial markets were of a mind opposite of that which prevails today: they would not believe that inflation could be eradicated. *Expectations* of continued and uncontrollable inflation remained high despite all behavior by the Fed to the contrary.

Arthur Burns was the Fed chairman from 1970-1978. "Easy money" policies – the setting of lower interest rates – of the early 1970s led to rising and eventually high inflation. Consumer prices jumped from 4% to more than 12% by the halfway point of Burns' tenure. Raising interest rates from 5% to nearly 13% tamed the inflation beast but also sent stock prices and the economy into a tailspin. The S&P 500 fell by nearly 50% in 1973 and 1974. This dramatic decline in the market and economy caused the Fed to lower rates in an attempt to spur economic activity and rescue the market.

Burns' low interest rates sowed the seeds of destructively high inflation in the late 1970s and early 1980s. This is because inflation does not always occur immediately but often with a lag. Yet while Fed chairman, Burns was considered tough on inflation.

After joining the Federal Reserve System in 1975, Paul Volcker was appointed Fed chairman in July 1979 for a term to begin the following month. On July 30, 1979, Volcker told the senate that the raging inflation of the second half of the 1970s was caused by excessive growth of the money supply. "There is no substitute for monetary discipline." Volcker immediately began raising interest rates in an attempt to quell inflation. In what is known as the "Saturday night massacre," Volcker raised interest rates by an entire percentage point on the evening of Saturday, October 6, 1979. Already at 10% at the time of his appointment, it took Volcker only eight months to march rates above 17%. They were north of 19% by mid-1981.

Determined to reduce inflation and increase the U.S. dollar's status in the world economy, Volcker had to overcome less than optimal conditions for raising interest rates. The economy of 1979 was already slipping into recession. Higher interest rates would likely exacerbate this condition.

Interestingly, the price of gold *rose* in the first few months of Volcker's intense attack on inflation. In fact, the price of gold actually doubled in the first five months of Volcker's tenure despite his hiking rates from 10% to nearly 14%. Conventional wisdom maintains that this should not happen. But, regardless of Volcker's actions, *expectations* of higher inflation were so firmly rooted that gold continued to soar. Only until the market recognized that he would not waver in restricting the money supply did it finally push down the price of gold. Gold miners, even after the peak in gold, continued their climb, many of which peaked later in 1981.

Today's market psychology is rooted in the belief that there will be no future inflation even though the Fed has held interest rates at 0% and increased the monetary base by roughly $2.5 trillion since 2008. The market can change its beliefs quickly, especially if outside forces provide a shock to market psychology.

Though it is often gradual, U.S. financial history is no stranger to periods when relatively low inflation suddenly burst into very high inflation. Inflation of 2.7% in June 1972 soared to 11.5% by July 1974. 4.8% inflation of December 1976 steadily climbed to twice that level within three years and reached 14.4% by May 1980. Even during a weak economy, efforts by the Fed caused inflation to jump 6% from negative 2.1% in July 2009 to 3.9% in September 2011. Prevailing market psychology forgets that what appears to be little inflation today can become significant inflation in the not-too-distant future.

Paul Volcker today remains of sound mind though he is discouraged by what could come of current Fed policy. Calling it the "most extreme easing of monetary policy," the legendary central banker says today's stimulus will not fix our current problems. "I think people think quantitative easing helps pep up the stock market and may reduce long-term interest rates a little bit. But I don't think it does enough to make a really significant difference in the basic outlook, which remains one of limited job creation in the private sector, but not really enough to reduce the unemployment rate at all rapidly." Late in 2012 he added: "There won't be inflation this year or next – not the dangerous kind. But the real question about loose monetary policy is: can you reverse it in time? That is always the biggest problem in central banking."

Just weeks ago, he had more to say: "Credibility is an enormous asset. Once earned, it must not be frittered away by yielding to the notion that a little inflation right now is a good a thing, a good thing to release animal spirits and to pep up investment.

"The implicit assumption behind that siren call must be that the inflation rate can be manipulated to reach economic objectives. Up today, maybe a little more tomorrow and then pulled back on command. Good luck in that. All experience demonstrates that inflation, when fairly and deliberately started, is hard to control and reverse."

REMEMBER WHEN WARREN BUFFETT "LOST IT"?

The price for shares of Warren Buffett's company, Berkshire Hathaway, recently reached a new all-time high. But you would not think it was possible based on these headlines: "Berkshire's Buffett-ing" or "Warren Buffetted" or "What's Wrong, Warren?" And that is because these are not today's headlines about the legendary CEO. They are a mere smattering of stories that questioned Buffett's skills in 1999 and 2000, during a tough spell for Berkshire's share price.

But, most importantly, it was neither a tough period for Berkshire's businesses nor the mental faculties of its leader. Beneath the surface of a lagging share price, Berkshire's numerous operating companies continued to go about generating large amounts of free cash flow for Buffett to invest. Yet by early 2000, Berkshire's shares sank to *half* of their 1998 price. Had Mr. Buffett "lost it," or was it actually a terrific buying opportunity presented by a stock market that routinely misprices securities? In contrast with the author of one of the aforementioned articles who naively wrote, "This might be the year that the rest of us got smarter than Warren Buffett," we thought it was an opportunity to buy or at least hold on.

The palpable anti-Berkshire sentiment created the chance to own a terrific business at a bargain price. That is because poor sentiment is usually *caused* by a low share price. Since the headlines mentioned above, Berkshire's share price is higher by nearly 200%. This return outpaces the overall stock market during the same period of time, including the much praised and highly priced shares of that era. (Shares that are "much praised" and "highly priced" are the opposite of value investments; everyone already likes them, often causing them to be overpriced. Accordingly, future returns from highly priced investments are likely to be worse than expected.)

Investors who missed the turn of the century opportunity in Berkshire were given another chance a couple of years later around the time *BusinessWeek* ran a piece titled, ''Has Warren Buffett Lost His Touch?'' Since then, Berkshire's price is more than 110% higher.

Headlines often tell the story of what ***already happened*** *to an investment's price.* Usually, if the story is in the news, it is already reflected in the share price. Major headlines rarely tell the story of an investment's actual *value* (value is critically different than price), especially as it relates to the future. Over time, we see repeatedly that when a solid company has a bout with poor share price performance, it usually pays handsomely to be bullish on that company or to at least hold tight. Wait for sentiment to turn.

Master investor John Templeton recommended holding on or buying more ''at the point of maximum pessimism.''

We have held Berkshire shares through thick and thin over many decades. At times when public perception believed that Berkshire was no longer a wise investment, we received much criticism for holding steady. At low cycles for Berkshire's share price we were actually instructed by a few clients to sell their Berkshire shares. This happened despite our dispassionate survey of the company which led us to believe that it remained an intelligent holding. We are pleased for the majority of our clients who held on.

To invest successfully, master investor John Templeton recommended holding on or buying more ''at the point of maximum pessimism.'' This applies to numerous facets of financial markets whether it is the prevailing perception of Buffett's acumen, the abilities of investment managers, conventional wisdom toward particular asset classes, etc. Years of satisfactory investment performance by investors with a contrarian viewpoint underscore the fact that it is often best to hold on or invest more when prevailing sentiment would normally lead you the other way.

COMPOSITE PORTFOLIO

In the three months ended June 30, 2013, we trimmed our holding of Medtronic and a Pitney Bowes bond matured. We initiated positions in the shares of Agnico-Eagle Mines (AEM), Transocean Offshore (RIG), and Weight Watchers (WTW).

AEM operates a handful of gold mines in politically safe jurisdictions, has a long track record of gold reserve growth, and recently took advantage of low gold prices by taking stakes in smaller mining companies. The company has paid dividends for 33 consecutive years, and the shares now yield more than 3%, a record high for AEM.

RIG is the world's leading ultra-deepwater drilling company. We expect the company to earn at least $6 per share for the next couple of years (giving the shares a P/E of 8 on our initial cost). RIG also intends to explore other ways to enhance shareholder value. Activist investor Carl Icahn is the company's largest shareholder and should help this cause. In the meantime, we earn a 4.7% dividend yield on our cost.

WTW operates the number one weight loss brand in the world. However, the company endured a bit of misfortune in the past year, including the loss of its lead spokesperson, nationwide fiscal cliff woes just ahead of Weight Watchers' peak season, and a large share buyback in 2012 at elevated prices. This helped send the shares down from north of $80 to the low $40s. We believe much, if not all, of the bad news is priced in, and the market may be ignoring future benefits that could accrue to the company. The obesity epidemic in the U.S. is large and growing (70% of adults are overweight and 35% are obese; 17% of children are obese), and weight gain is increasingly seen as a cause of other major medical problems and expenses. WTW has much room to grow in the world weight loss market (though the leader, it holds only a 4% share of the global market) as well as in the corporate and healthcare sectors. The shares yield 1.5% with room for dividend growth. We expect WTW will provide a satisfactory return over the long-term.

Composite Portfolio Holdings
as of June 30, 2013

Security	Pct. Assets
Berkshire Hathaway	9.4
Federated Prudent Dollar Bear Fund	6.6
Market Vectors Gold Miners ETF	6.5
Newmont Mining	6.0
Central Fund of Canada	4.8
Microsoft	4.8
Johnson & Johnson	4.3
Federated Prudent Bear Fund	3.2
Wal-Mart Stores	3.2
AIG	2.8
Medtronic	2.7
Pan American Silver	2.3
Pfizer	2.3
Fairholme Fund	2.1
Merck	1.8
Abbvie Inc.	1.6
Chesapeake Energy	1.6
Abbott Laboratories	1.5
Leucadia National	1.2
Becton, Dickinson & Co.	1.2
Markel	1.2
CVS/Caremark	1.1
Safeway Inc., 6.250% due 3/15/2014	1.1
Berkshire Hathaway, 7.125% due 10/15/2023	0.9
DirecTV	0.9
Fairfax Financial	0.9
Transocean Inc.	0.8
ConocoPhillips	0.8
Chevron	0.7
Staples Inc., 9.750% due 1/15/2014	0.7
Laboratory Corporation of America	0.7
Weight Watchers Intl	0.6
Agnico-Eagle Mines	0.5
Phillips 66	0.5
Other	1.8
Cash Equivalents	16.9
Total	100.0

Cheviot's Balanced Portfolio Composite (the "Composite") includes all fully discretionary, fee-paying accounts over $250,000.00. The Composite assets are allocated principally among the following asset classes: equities (common stocks), fixed income (bonds) and cash. Cash is allocated in accordance with the views of our firm's investment officers regarding the relative desirability of being more or less fully invested in other asset classes from time to time.

In the Composite, client accounts are combined for performance reporting purposes to provide a "Composite" return. The Composite represents actual money invested for clients. The table on page 15 sets forth the holdings in our Composite as of June 30, 2013.

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 information contained herein is based on internal research derived from various sources and does not purport to be statements of all material facts relating to the securities mentioned. The information contained herein, while not guaranteed as to accuracy or completeness, has been obtained from sources we believe to be reliable. Opinions expressed herein are subject to change without notice. Cheviot Value Management 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.

CREDITS

Darren C. Pollock and David A. Horvitz authored this issue of *Investment Values.* Typographic design, formatting and printing are by Supreme Graphics of Hawthorne, California.

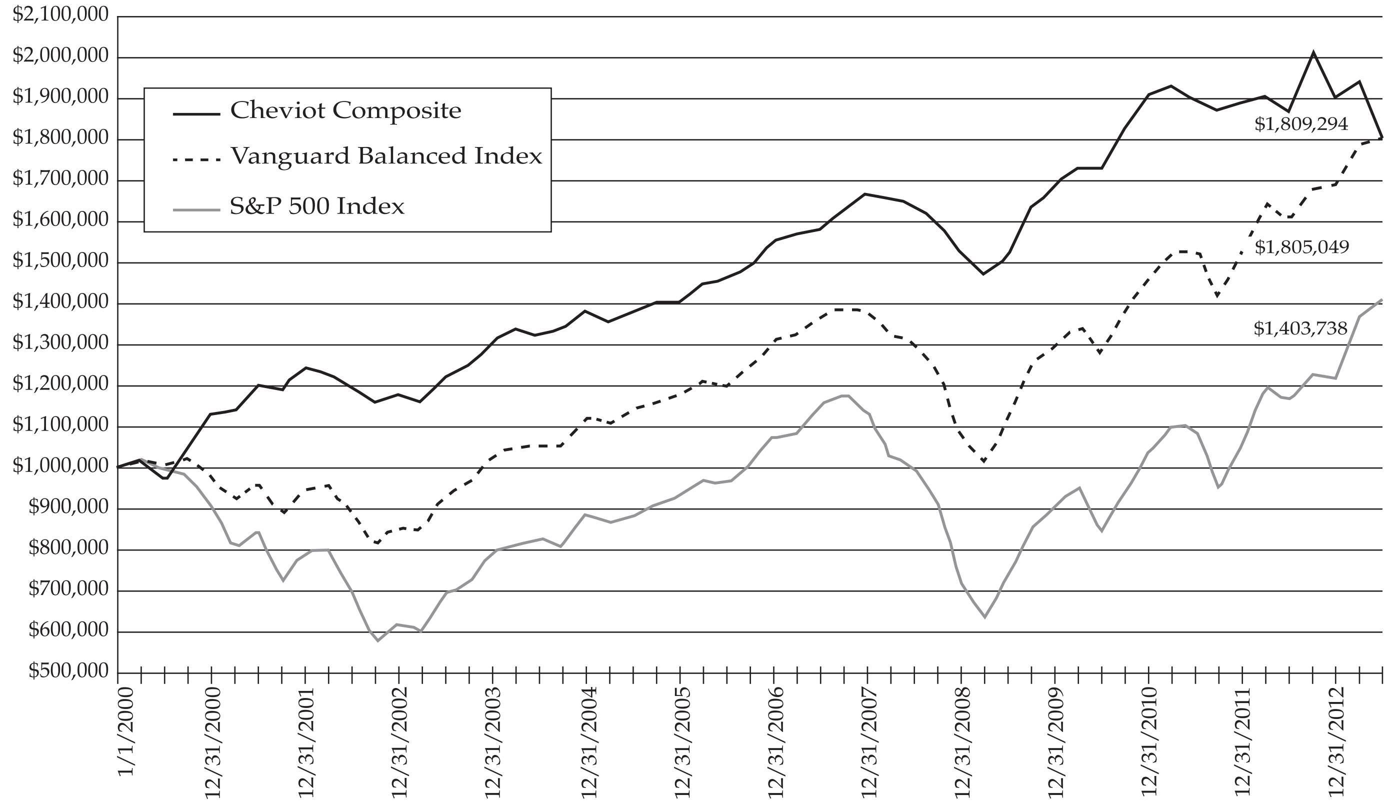
NOTES

[1] See our April 2013 letter, specifically, "The Siren Song of the Market" for a summary of the longer-term performance of typical market participants at http://cheviotvalue.com/publications/investment-values/

[2] Grant continues: "Which to me makes the sell off in gold that's been relentless even more anomalous. The Fed is coming out and telling you that they are not going to do less of what they're doing barring some sudden upsurge in activity which seems quite unlikely." More on this subject elsewhere in this letter.

[3] http://ceo.ca/frank-giustra-long-form-interview/; http://www.youtube.com/watch?v=VfHm_ng6-UQ; http://www.theglobeandmail.com/report-on-business/industry-news/energy-and-resources/where-eight-renowned-investors-think-commodity-prices-are-going/article11435677/?page=all

Growth of $1,000,000 Initial Investment on January 1, 2000



COMPOSITE PERFORMANCE DISCLOSURE

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 of 1% per annum. The time period commencing 1/1/2000 is used as a standard measuring point as that is the date current investment personnel have been active in portfolio management.

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 Vanguard Balanced Index Fund is a mutual fund that reprereseents the typical balanced fund investment and seeks long-term growth and income by investing approximately 60% of its assests in equities and 40% in fixed income investments. Benchmark returns are shown for Investor Class shares. Performance reflects pre-tax returns and includes changes in share price and reinvestment of dividends and capital gains and is net of management and operational expenses charged to the fund.

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 CVM Balanced Portfolio Composite has been examined by independent verifiers for the periods from January 1, 2000 through December 31, 2011. A copy of this examination is available upon request. For further discussion on our composite, see: http://cheviotvalue.com/performance/composite/

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