

# ValueWorks

Quality assets. compelling valuations.

Volume 7,3

Q3 2009

This quarter our portfolios continued to participate in a significant market advance. Specifically, the S&P 500 advanced 15.6% in the quarter, now registering a 19.26% advance for the year. The Dow posted a similar 15.8% gain for the quarter and is now up 13.5% for the year. In the same periods our portfolios have advanced significantly more: 16.4% for the quarter and 40.5% for the year (through 9/30 GROSS of fees). See the performance tables on p. 4 for more detailed information.

Investors who remain fixated on near-term market gyrations may be adrift and uncertain given the massive swings of the past year. As a consequence, those who position their portfolios on "market views" are not generally participating in this advance. But those who attempt a slightly longer-term perspective and focus less on near term gyrations – and we include ValueWorks in that category – seized upon the opportunities that were created by last year's turmoil.

One result of this approach was that for several months our results seemed dismal, and the portfolio values were much lower. However, I see the gains we are now realizing to be a direct result of our confidence in putting money to work in that meltdown. Because we did not try to time the bottom, but rather kept putting money to work in individual investments that seemed quite unusually underpriced, we were well positioned to benefit from the rebound we are now seeing.

Of course the question is now: where do we go from here? My confidence in the outlook for investors is based upon three considerations. First, it seems clear that we are past the lowest point in the business cycle and that conditions are in place for improved economic conditions to unfold gradually over the next several years. Second, valuations remain, in my opinion, uncommonly compelling. And third, those investors that were shaken out of their investment discipline and have not been participating in this advance will begrudgingly seek to put money back to work, driving prices higher, as they come to terms with the first two propositions.

My confidence in where we are in the business cycle is of course central to this conclusion. It is on the one hand based upon seeing policies in place that I understand create better conditions, and on the other hand, ample evidence that we are actually seeing an improvement in economic activity.

Those that have been reading my letters over time know that I consider monetary policy (i.e. "access to capital" or "the cost of money" – and generally controlled by raising or lowering the Fed Funds rate) to be the principal tool through which economic activity is modulated. Make money cheap and easy, and you get an expansive, inflating economy. Make money really expensive and hard to come by, and you get a contraction. Get the adjustment just right for a while and you get a gradually growing economy without inflation. Go too far from one to the other, and you get a boom-bust economic cycle.

Consistent with this model, it was tight monetary policy that led to a contraction in the first place. In my letter in the first quarter of 2008, I wrote that a recession had likely begun in the previous quarter, and that the proper policy response was to ease monetary policy to reverse a decline. At that point Fed funds had been modestly lowered from a very restrictive 5.5%. Over the next eight months policy makers made some efforts to provide liquidity and enhance confidence. But they surely did not pull out all the stops.

In fact they did several things that undermined those efforts and made money harder to come by. (Not least of

which was to constantly threaten the banks with government takeovers. Banks that are told they are undercapitalized and are at risk of government takeover are not in a position to provide the system with more liquidity and make more loans.) Once the government actually took over Freddie Mac and Fannie Mae, it massively undermined confidence, drained liquidity and created a quiet but ruthless run on the financial system. Lehman succumbed four days later. That unleashed a full blown panic.

The efforts made to pump liquidity since then have been orders-of-magnitude greater than the mixed efforts up to that point. They have been extraordinary and nearly unequivocal. And apparently, they have been up to the task, as the collapse has at very least stabilized.

Those who do not expect easy access to capital and cheaper money to result in an improving economy and the return to an economic expansion generally offer one of the following critiques. One is that easing conditions did not work to avert the recession and implosion – that monetary policy did not,

## Top 10 holdings\*:

1. Bank of America PFD
2. Micron Technology
3. Wells Fargo PFD
4. 3M Company
5. Constellation Energy PFD
6. Boeing Company
7. Dow Chemical Company
8. Boston Scientific
9. Chesapeake Energy
10. Rowan Companies

—as of 09/30/09—

\*see notes on p4 for additional information

does not and will not work. Their expectation is that once this "minor market holiday" of the past six months runs its course, we will again descend into another decline. I think the mistake they are making is failing to distinguish between the conclusion that the amount of easing in place pre-September did not work (which it didn't) as opposed to the conclusion that any amount of easing would not have worked.

My interpretation is that, in hindsight, clearly not enough was done to provide adequate liquidity pre-September and pre-panic. The notion that policy makers did all they could to create liquidity and inflate the system before September is belied by all the extraordinary measures that were put in place post-September. Those increased efforts have now slowed the contraction. Previous periods of contraction have been reversed with similar tools. With easier access to money, (not to mention all the fiscal stimulus that is yet to be spent) I see it as highly likely that we are well on our way to transitioning to an expanding economy that will have room to grow for several years.

The other critique offered is that all this cheap money will do nothing more than set us up for another bubble. There, I'm somewhat in agreement. That is very much what I think will happen again, just as it has so many times up until now. Over the next several years, money should become easier to come by, a fuller measure of confidence will return and that confidence will in some areas grow to ebullience. The business cycle will have turned. We will be in a period of strong growth, higher valuations (likely well above previous highs) and at some point likely more bubbles will appear. And at that point I expect policy makers to start to make money harder to come by to cool the excess liquidity and slow down the overly aggressive things people are doing. I see that as the likeliest outcome because I do not think this is either the first or the last business cycle we will go through.

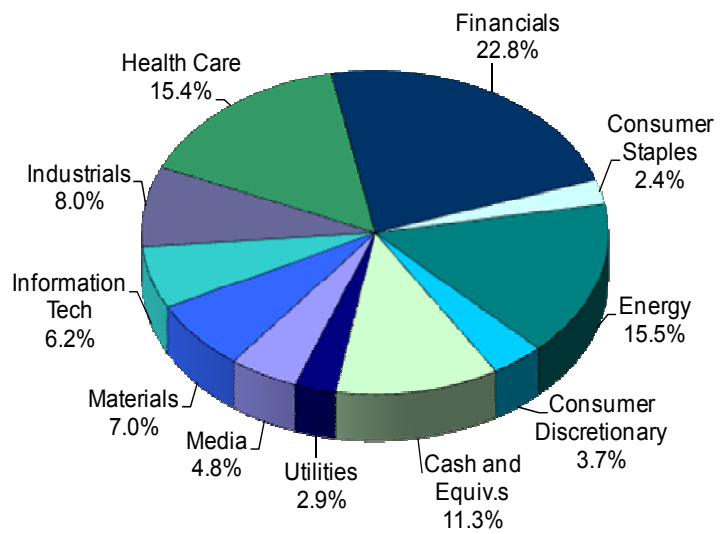
Because we are still very early in this cycle, the opportunities for investors remain exceedingly compelling. It is true things are not as cheap as they were last March. But they are much more modestly valued than they were two years ago, when the S&P 500 was 35% higher than today's level. And they are even more modestly valued than they were ten years ago, back in 1999 when the S&P first approached those levels. One can easily make that case based upon a big-picture approach. But my conclusion is based upon a bottoms-up, stock by stock assessment that in the end underlies what we at ValueWorks bring to the table as investors.

Some investors came into this period considering themselves long-term, disciplined equity owners who would not be shaken by market gyrations. Those that stayed with that discipline saw meaningful declines for a short period, but are already beginning to reap the rewards of maintaining their course. I do not expect those investors who were able to keep their composure and long-term view through the gyrations of the past twelve months to suddenly become emotional market-timers now. I hardly see them selling their holdings at these levels.

On the other hand, those that did get shaken out of their exposure are now sitting on the sidelines with record amounts of cash. Most of those investors will be hesitant and reluctant to put that money to work. But the longer the environment remains stable, and as the economy transitions from contraction to expansion (which may have happened in the third quarter), the confidence of those investors will slowly return. Right now, the most common theme I hear from potential investors is that they are waiting for another decline so that they can put money to work. They are all out there looking for an entry point. I expect those potential entry points to continue to move higher and higher over the next several years. As a result, those on the sidelines will begrudgingly and belatedly be forced to put money to work at increasingly higher levels.

— Charles Lemonides, CFA

**Sector Diversification--  
Capital Appreciation Composite**



**Contact:**

**ValueWorks LLC**  
1450 Broadway, 42<sup>nd</sup> floor  
New York, NY 10018

**email:**

[info@valueworksllc.com](mailto:info@valueworksllc.com)

**Call us:**

212 819 1818 (NY)  
212 819 1463 (Fax)  
866 567 4523 (Toll Free)

**Visit us on the web:**

[www.valueworksllc.com](http://www.valueworksllc.com)

# ValueWorks

critical thinking. independent research.

## **Defining our Philosophy:**

**At ValueWorks we define value investing as buying the best-quality assets at the best possible prices.** We like to think of ourselves as bargain hunters: it is our goal to pay only \$0.50 to \$0.75 for \$1.00 worth of assets. We evaluate the component parts of a company, assigning each of its assets a dollar value that, when added together, comprises the underlying value of the company; if this is higher than the company's stock price, we consider it an investment opportunity.

## **Defining our Process:**

**1) Identification.** We monitor the financial markets to identify securities that match our investment criteria—focusing on opportunities that appear misunderstood by the general market.

**2) Appraisal.** First we identify the assets; then we appraise them. This allows us to determine the company's *underlying value*. We then decide whether the assets are of high quality and therefore likely to appreciate over time.

**3) Assessment.** Here we assess any claims against a company's assets; we then compare the market price of the claims to the company's *underlying value*. If a particular security trades at a discount, we identify factors that could eliminate the valuation gap and increase its price. We then make a decision on the purchase of the security.

**4) Re-Evaluation.** We continuously monitor our positions to determine if our original investment thesis still applies, taking necessary action to optimize our portfolio.

**5) Exit.** We exit a position when a security either reaches full valuation or changes in its outlook invalidate part of our original thesis.

Our objective is uncomplicated, but achieving it requires a high level of research, expertise, discipline and independent judgment. By applying this framework consistently we remove emotion from the investment decision making process, enabling us to capitalize on inefficiencies built into the market.

## **About our Portfolio Structure:**

We believe risk can be better contained through educated security selection than through overdiversi-

fication. Consequently, our position sizes range between 3 – 5 % of the overall portfolio value. Fully invested portfolios tend to hold 25 – 35 individual investments.

We enter investments that we view as 25 – 50% undervalued and sell them when we see them as fairly priced. Our anticipated holding period tends to be one to two years which results in only modest portfolio turnover.

Because our decisions are based on research and sound fundamentals we view depressed price action on our securities as buying opportunities rather than sell signals.

We use senior debt and preferred instruments—offerings that can be easily misunderstood by traditional equity or fixed income investors—to gain equity type returns on safer vehicles.

## **About our Client Services:**

ValueWorks provides independent investment management on an individual account basis. Our clients receive the benefits of owning securities directly, coupled with the advantages of having a dedicated portfolio manager.

Working directly with your financial consultant, we evaluate your investment profile and build a plan designed to meet your specific goals.

As a high-end investment alternative, you receive:

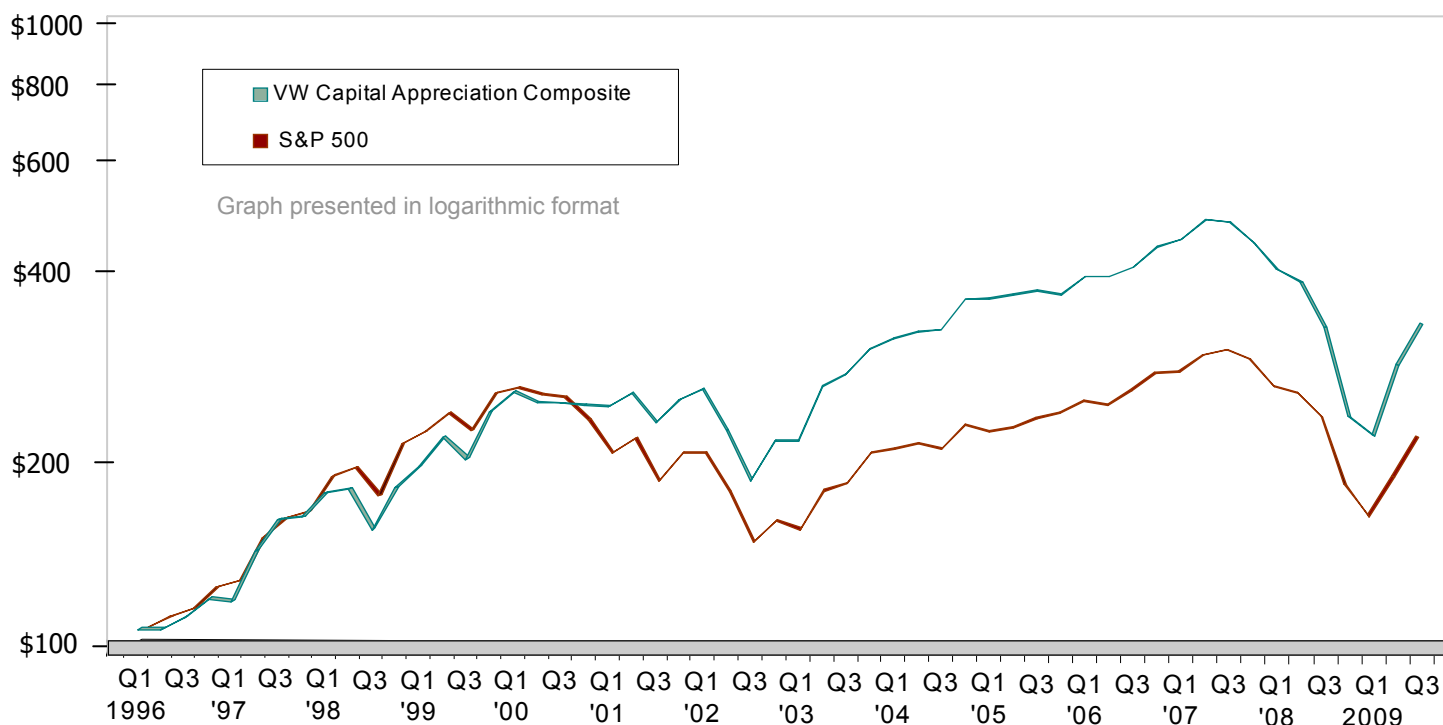
- Individual review of your portfolio requirements
- A separately tailored portfolio created and maintained to your investment objectives and risk tolerance
- Access to the Portfolio Manager on an ongoing basis with timely and responsive communication
- Flexibility to meet your changing tax requirements and investment needs
- Comprehensive quarterly performance reports.

Working within the framework of our value investment discipline, we build portfolios that cover a wide spectrum of risk-tolerance, from aggressive to much more conservative and income oriented.

# ValueWorks Performance Review

3rd Quarter: June 30th, 2009—September 30th, 2009

## Historical Growth of \$100 (gross of fees)



## Trailing Performance Data

	ValueWorks' Capital Appreciation Composite			ValueWorks' Balanced Composite		
	Gross of fees	Net of Fees	S&P 500	Gross of fees	Net of Fees	Blended index*
Q3 2009	16.43	16.06	15.60	16.24	15.82	9.58
YTD	40.47	39.12	19.25	37.94	36.44	12.62
1 year	1.31	-0.01	-6.92	6.23	4.66	3.15
5 year	0.52	-0.84	1.01	3.02	1.50	3.58
7 year	8.62	7.12	5.85	9.79	8.14	5.87
10 year	5.17	3.68	-0.15	6.91	5.21	3.61

\*The "Blended Index" is a calculation comprised of 50% S&P 500 and 50% Merrill Lynch Domestic Master Bond Index.

The above benchmark indices are unmanaged indices. The benchmark performance numbers reflect the reinvestment of dividends and interest but do not reflect the deduction of any fees or expenses. ValueWorks' value investing style is not limited to the securities in any of the above indices and utilizes specific investment techniques which are not utilized in the above indices and which may or may not increase volatility. Returns include all dividends, interest, accrued interest and other cash flows received as they may result from the implementation of a particular investment strategy. Trade date accounting has been used. Results for the full period are time weighted. Accounts are included in composite at the start of the first full period under management. From 1996—Q1 1998 exiting accounts are included through the period in which they left. Starting in Q2 1998 exiting accounts are included through the last full period under management. Results were generated at other firms prior to 9/30/01. Information on other composites is available.

As of 9/30/2009 the Capital Appreciation Composite consisted of 240 accounts and \$60,452,138 in assets; while the Balanced Composite consisted of 76 accounts and \$30,912,488 in assets. Together this represents 99.06% of total accounts and 76.02% of total assets.

**Past performance is not a guarantee of future results.**