VALUEWORKS
QUALITY ASSETS COMPELLING VALUATIONS

VOLUME 16,1 FIRST QUARTER 2018

After a 15 month long steady-as-she-goes market advance, share prices turned much less steady since the first week of February. That said, while the market gyrated with quite a bit of force for the past two months, and while there were plenty of instances where individual share prices swung sharply, both the overall indexes and our accounts ended the quarter valued quite similarly to where they began: the S&P lost -1.22%, the Dow shed -2.49%, and the tech heavy Nasdaq tacked on 2.32%. Our Capital Appreciation group of accounts was down 2.04% (gross – see details on page 6).

This type of reversal and very different market tone invites an examination of where we are in the market cycle and where we are in the business cycle. Clearly, the market action in the quarter was simply unlike what we have seen for the previous year and a half. So the question is whether this was simply a "white noise" blip that signifies nothing and resolves itself with a continuation of the same trends that were in place, if it demarks a transition from an early-midcycle market advance to a late-stage bull market, or whether it represents a market top with an extended period of stagnation/decline ahead.

The strongest argument is that these gyrations are consistent with a transition to a late-stage market advance. This in turn suggests a duration of something like two to five years and the major indexes topping out at levels 35 - 100% higher than today. On the surface that may seem a particularly optimistic call, but getting it right is important due to the very difficult challenges present for investors in the late stages of a bull market.

I discount the notion that this is a market top given the positive outlook for the economy over at least the next twelve months. At the same time, the magnitude of the swings in the overall indexes, and the sharp movements in leading equities is simply inconsistent with an inconsequential blip.

An economy that is growing, healthy and likely to remain so for at least another year is not consistent with a market top and the beginning of a bear market. The economy added over three hundred thousand jobs in February (which is consistent with 3% GDP growth), housing demand is healthy, there is increased investment in the energy sector with oil prices over $60 a barrel, and the fiscal stimulus of a tax cut is about to give a further economic boost. We are on a growth trajectory and should remain so unless something knocks us off of it.

Through this market gyration, there has been a lot of discussion on whether policymakers are about to push us off of this positive path – that if policy makers make really bad decisions, we can expect bad outcomes. But just because they might, does not mean they probably will. The most standard risk is that the Fed raises interest rates hard

and fast enough to choke off growth. The unique experience of the past decade, with Fed Funds bound to zero for such an extended time, means there is no precedent for what will happen as rates are changed. That is concerning. We cannot be sure how the economy will react as rates are raised. But there are two other factors to consider. First, while monetary policy does work, it does so with a lag. It takes a year or two for higher rates to dampen growth, so even if rates today were high enough to slow activity, that slow down would not typically begin for another twelve months. In 1996 Fed Funds were raised to 6 ½%, but the economy did not slow until 2000. Second, historically Fed Funds under 3% have been accommodative; that level and below has typically boosted economic growth. To put it in perspective, by the beginning of 2008 Fed Funds had been lowered from 5½% to 3% to stimulate economic activity. After Bear Sterns collapsed in March, they were lowered ¾% to 2¼%. That was viewed as an emergency-low-level to keep the economy moving. The more assertive views today have Fed Funds moving up from 1¾% towards 2½% in the next twelve months. My sense is they will move more slowly than that. While conditions are different, and there are risks, a Fed Funds rate under 3% has not historically resulted in economic contraction. Beyond that, the recently passed fiscal stimulus will be hitting peoples' pockets between now and year end. That should more than offset modestly higher interest rates.

TOP 10 HOLDINGS

1. Cliffs Natural Res 6.25% Due 10-01-40
2. Qualcomm Inc.
3. Brunswick Corporation
4. Corning Inc.
5. New York Times Cl A
6. Comcast cl A
7. American Express Co.
8. Amgen Inc.
9. Transocean Ltd.
10. Eli Lilly & Co.

—As of 3/31/18—

*see notes on pg 4 for additional details

The other well discussed policy risk is that of a trade war. It is true that if this scenario were to really accelerate, equity markets would likely sell off. But the simple fact that policy makers are being aggressive in trying to narrow the US trade deficit is simply not in and of itself an economic negative. It is a good thing that the US strives to lower its trade deficit. Bellicose language has its own risks, but the global economic system is adequately complex and nuanced to allow for that language to be absorbed and transmuted into measured improvements in the overall balance of the system. The bombast of a single politician – even one centrally placed – has rarely resulted in economic collapse.

It is helpful to identify where we are in a market cycle in order to understand why portfolios are behaving certain ways and what adjustments should be made. For example, coming off a market bottom, having exposure to high quality, solid names can work well as they tend to advance as overall markets recover. It also can be a good moment to own high dividend-paying defensive stocks because they will throw off cash and appreciate as risk premiums decline. At the top of a market cycle, those dividend-paying names can easily post declines as interest rates steadily move higher. A well-constructed portfolio of high quality stable names will tend to underperform a portfolio built around high growth, high beta, aggressive names as investor enthusiasm reaches a peak. And the time to build exposure to cyclical stocks is when the economy is performing poorly and the share prices are depressed – you buy cyclical stocks at peak multiples of trough earnings and sell them at trough multiples of peak earnings.

If it turns out to be right that the first quarter was a transition period from a mid-cycle market advance to the beginning of a late-cycle advance, then we can expect the investments that have worked up to now to perform quite differently in the period ahead. One thing to look forward to as this scenario plays out is that we will get market leadership from new and exciting places. By definition, we cannot know what these are at the beginning of the period because their growth and emergence has not happened yet. And at the early stages of investor interest, they seem like marginal and silly ideas. There was a moment when cars and airplanes were silly ideas. Twenty-five years ago smart phones and mapping the genome were science fiction. Today for fifty dollars you can find your relationship to a specific woman in Northeast Africa from 15,000 years ago and discover that you are predisposed to lactose intolerance (and other more impactful specific medical conditions). What do we learn when we collect genetic data on tens of millions of people?

Is the next leg up going to be driven by driverless cars? Blockchain and bitcoin? Nanotechnology? Replacement human parts? Renewable energy? Virtual reality? Or something else? I consider it telling that such fantasy-type discussions are happening in financial circles. Those discussions do not happen in difficult economic times; they happen as we get more exuberant. Hemlines are going up.

But the other thing that happens is that market leadership gets increasingly narrow and – at the final stages – carried by unsustainably extended stories and themes. In heady times, sensible investments underperform.

In the later stages of a bull market, companies with the most exciting prospects attract all the attention and trade at richer and richer valuations. Companies that have fair growth prospects may advance a bit, but not like the growth darlings. The difference between high priced securities and low-priced securities gets bigger and bigger. In the end, the market is carried by companies that become inanely priced and that will see huge declines once the music stops.

The strongest argument is that these gyrations are consistent with a transition to a late-stage market advance.

To us, the key to managing through these periods is to stock the portfolio with sensibly priced investments that have the prospect of getting revalued by the excited crowd. That is not a classic value investment discipline. We strive to do something more nuanced than buy bad businesses at low prices. We strive to buy value and sell growth; to buy businesses when their prospects appear bad and sell them when their prospects appear good.

An environment where investor darlings get increasingly expensive and tainted companies trade at ever larger discounts can be quite good for our approach. Because when we are able to buy an unloved issue and see it reappraised as one with winning characteristics, the move higher is all the larger. Buying an out of favor stock at 11 times earnings and seeing it get attention and move to 18 times earnings is good. Buying it at 8.5 times earnings and selling it at 24 times is better.

Over the past two quarters we have been quite active on the buy side. We most recently added Transocean Ltd at under $10 per share. While the company is currently quite out of favor, these types of investments can easily trade at 2 times book value when in favor – and book value is currently $32 per share. We also bought Newell Brands, maker of consumer products ranging from Sharpie pens to Marmot skiwear. The shares are down from $55 last summer to $25 on disappointing operating results. They are now trading at 10 times earnings. We see new leadership translating to better results and the shares trading above their old highs in the next 18 – 30 months. Spirit Aerosystems was bought in February, in the midst of the sell-off. They make fuselages and wing structures for Boeing and Airbus airplanes. While the stock is close to its high, it trades at 13 times forward earnings with very clear earnings growth for at least three years. Viewed simply, they should have operating results quite similar to Boeing, and Boeing trades at 23 times forward earnings. Bed Bath & Beyond was also added to the portfolio in the past six months and is now trading at 7.5 times earnings and an enterprise value of 3 times cash flow. If their "omni-channel" retail strategy works as well as I think it is currently, earnings will begin growing again by this time next year and the shares could credibly be revalued as a growth name and priced three times where they are today.

In conclusion, I think the next several years can turn out to be quite challenging for good investors not because the markets decline, but because of how they go up. We may have just had a first taste of this type of challenge as Amazon, NVIDIA, Netflix and Cryptocurrencies created the sense of investors reaping windfalls. As they marched higher into January, frenzied buying by investors who had been just watching brought a near-term speculative top. Then the rug was pulled out from under them. That may prove to be a mini-version of what plays out more broadly over the next 2½ to 5 years. Those names may not lead the next wave of speculative fervor, but the last leg of a bull market will eventually be led by dangerous speculation. While this happens around us, we will work to find ways to participate in these turbulent up markets without exposing ourselves to the eventual march off the cliff. (We are doing that by stocking the portfolio with names that can credibly be revalued as growth names if our thesis plays out, but that should perform reasonably well even if it does not.) Because it is one thing to put capital at risk in the midst of market collapses. We do that. We do it knowing that we will see losses until the collapse is over, but that if we do it right those losses will quickly reverse themselves positioning us for the upside. That is a different type of risk than getting further invested in over-extended securities into the top of a bull market. This we do not do; because once the speculative fever is gone, the downside is harsh and the declines do not reverse themselves.

-Charles Lemonides, CFA

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.

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*

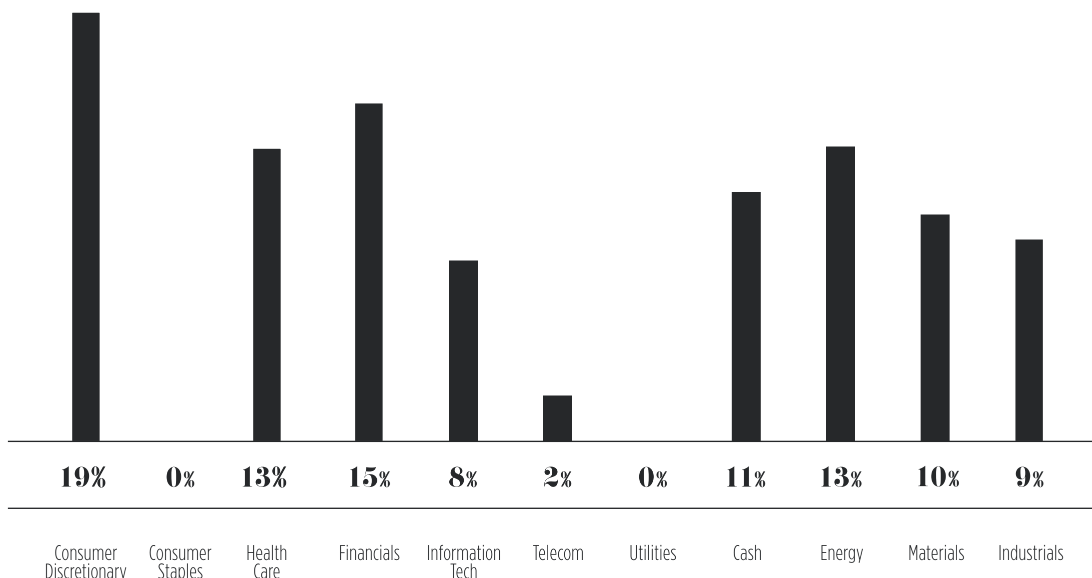
We exit a position when a security either reaches full valuation or changes in its outlook invalidate part of our original thesis.

Objective

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.

SECTOR DIVERSIFICATION

CAPITAL APPRECIATION COMPOSITE



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.

OUR PORTFOLIO STRUCTURE

We believe risk can be better contained through educated security selection than through over-diversification. Consequently, our position sizes range between 3 – 5 % of the overall portfolio value. Fully invested portfolios tend to hold 25 – 35 individual investments.

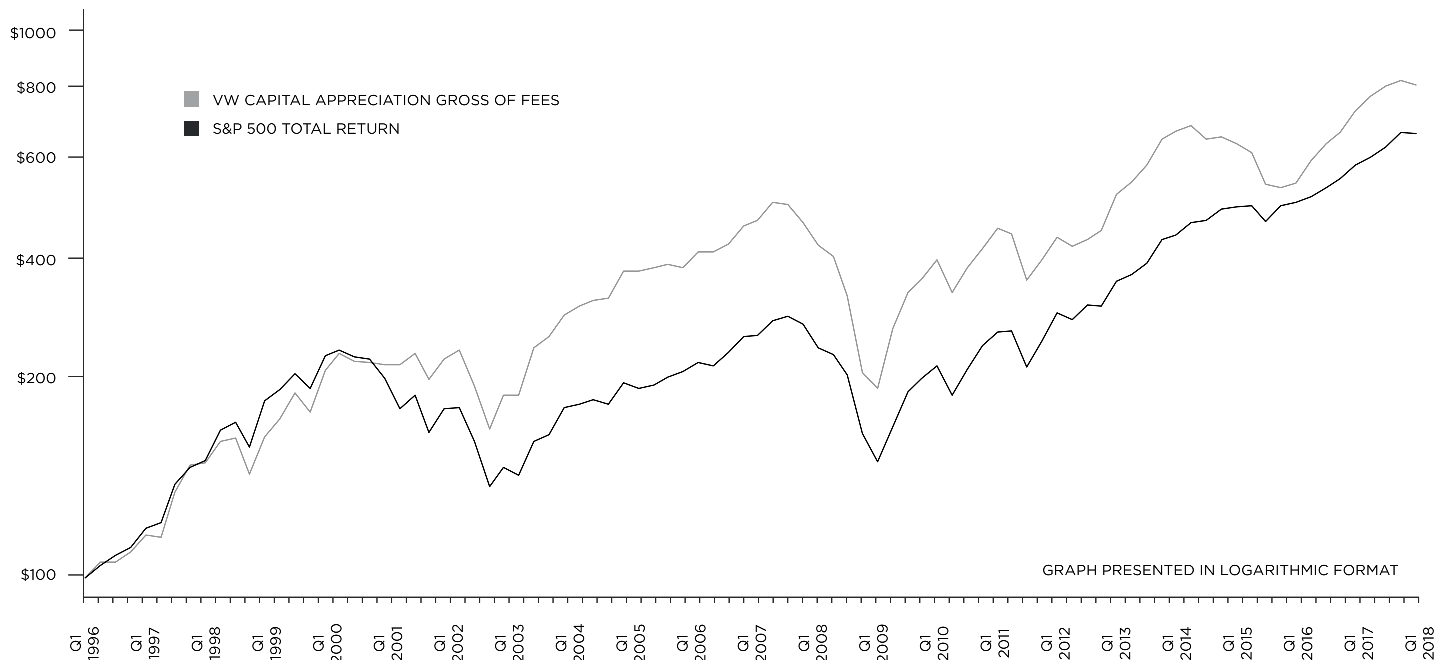
We enter investments that we view as 25 – 50% undervalued and sell them when we see them as fairly priced. Our anticipated holding period tends to be one to two years which results in only modest portfolio turnover.

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.

PERFORMANCE REVIEW

FIRST QUARTER 2018 December 31, 2017—March 31, 2018



TRAILING PERFORMANCE DATA

VALUEWORKS' CAPITAL APPRECIATION COMPOSITE

	GROSS OF FEES	NET OF FEES	S&P 500 TR
2018 Q1	-2.04	-2.32	-0.77
1 year	11.26	9.99	13.99
3 years	8.56	7.29	10.79
5 years	9.62	8.30	13.32
10 years	6.98	5.64	9.46
Life*	9.79	8.22	8.79

*Life is 22.25 years (inception 1/1/1996)

VALUEWORKS' BALANCED COMPOSITE

	GROSS OF FEES	NET OF FEES	BLENDED INDEX*
2018 Q1	-2.25	-2.58	-1.12
1 year	8.95	7.52	7.48
3 years	6.76	5.33	5.99
5 years	8.71	7.23	7.32
10 years	7.05	5.56	6.87
Life*	10.06	8.37	7.30

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

PAST PERFORMANCE MAY NOT BE INDICATIVE OF FUTURE RESULTS.

This Newsletter is intended to be presented with the Capital Appreciation Fact Sheet which contains additional disclosure information.

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 on request. Investments in this strategy may lose value.
This material is approved for client use.

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