VALUEWORKS
QUALITY ASSETS COMPELLING VALUATIONS

VOLUME 16,2 SECOND QUARTER 2018

The selective market climate we wrote about in the first quarter remained in place through the second quarter. For the year the Dow is down -0.7% while the Nasdaq 100 is up 10.7%. For the quarter the relative numbers are up 1.3% for the Dow; 7.3% for the Nasdaq 100. Our Capital Appreciation group of accounts was up for the quarter 5.3% (gross – see details on page 4).What is driving this disparity is that a few names that have caught investor attention are moving up with enthusiasm while most names are meandering without direction.

Increasingly, investors willing to take their chances on high-flyers are reaping rewards while those focusing on downside protection are left on the sidelines. This can be seen in the relative performance of the Russell growth index, which currently sports a P/E of 172 times and advanced 9.7% for the first half compared to a -1.7% decline for the Russell 1000 value index.

Our solid performance in this environment was similarly generated by big gains in just a couple of holdings. Specifically, Transocean Ltd, which we purchased late in the first quarter, advanced 35% in the second quarter. Bombardier, which we purchased late in a previous lifetime, also tacked on 35% for the quarter. Those two names contributed almost half of our second quarter advance.

While we can expect short periods where this overarching trend reverses, the setup is for the general trend to be in place for several years. Heckling over trade wars and government disfunction does not change the underlying reality that the US economic picture is presently quite good. The US continues to add a couple hundred thousand jobs per month and corporate profits are growing. While we can expect policy makers to eventually raise interest rates enough to slow this economy down and trigger the next recession, that economic peak can be three to five years away. When an economy has the underlying momentum this one has, it does not change course wantonly.

If the economy continues to expand from here—as it did from a similar position through the late 1990's—it will be natural for investors to become more and more confident as the market bounces higher from each minor correction. As that plays out, riskier securities offering the prospect of higher growth will attract more excitement than issues promising downside protection. We are starting to see this pattern playing out now and it is a cycle that feeds on itself. It is part of the mass psychology that gives us business cycles.

As we wrote in our last letter, these are hard conditions for prudent investors to navigate successfully. The indexes move higher on the back of increasingly over-priced issues. The best returns are captured by those taking increasingly imprudent risks. As the bubble inflates, those taking pencil to paper and evaluating investment merits with a critical eye will decline to buy those over-extended issues and will not participate in the advance. It will be even worse for those value investors that limit their interest to "classic value" sectors and metrics.

But we consider this a positive environment for our particular value approach. We are distinct from the more traditionally defined value manager in that we are not limited to sectors that generally trade at low

valuation multiples. Our portfolio is not typically stocked with financial companies, cable companies and tobacco stocks even though these are low multiple groups that dominate the value indexes. Rather we focus our efforts on uncovering true diamonds in the rough. We look for issues that are trading at low valuations relative to their underlying assets today but that we expect to trade at above average multiples at some future point. We look to buy value stocks and sell growth stocks. This environment where the unloved fall far and the loved loft ever higher is good for our approach in two ways. First, the universe of potential diamonds is large, as many stocks languish. Second, when a security moves from the unloved camp to the loved camp, the change in price is larger than it is at other points in the market cycle.

We have been quite active in the past twelve months stocking the portfolio with a wide array of very different securities that meet these criteria. The result of these changes is that the portfolio today looks quite different than it did 12 and 24 months ago. Our recent purchases are not 'right up the middle.' Over the past twelve months we have put money to work in: Newell Brands, Tidewater, Kulicke & Soffa, Bed Bath and Beyond, Transocean, Spirit AeroSystems, Brunswick Corp, and Qualcomm. The only unifying theme among these investments is that—in our estimation—we are buying their underlying assets for much less than they are worth in the real world, and that they have the chance of being reassessed as investor favorites as this market cycle runs its course.

One tricky part of this strategy in this climate is that investment returns are likely to be streaky, irregular and not particularly corelated to index returns. I would argue that the portfolio now holds 15 or so issues that could each credibly double in any given year and still be fairly valued. If only one does, we might have a so-so twelve months. I would be surprised if we do not go through a period like that sometime in the next three or four years. But if three or four add 50%, we could easily post 25%+ type returns in any given period. I would be even more surprised if we don't get one or two of those before this market cycle reaches an ultimate peak.

This potentially streaky return profile will make it harder for the average investor to avoid one of the worst investment mistakes – building exposure to over-valued issues near a market top. As markets get increasingly heady, more and more buyers will pile into what has been working. As this advance continues and builds steam, we will remain disciplined and exit investment winners rather than pile into them at the top.

-Charles Lemonides, CFA

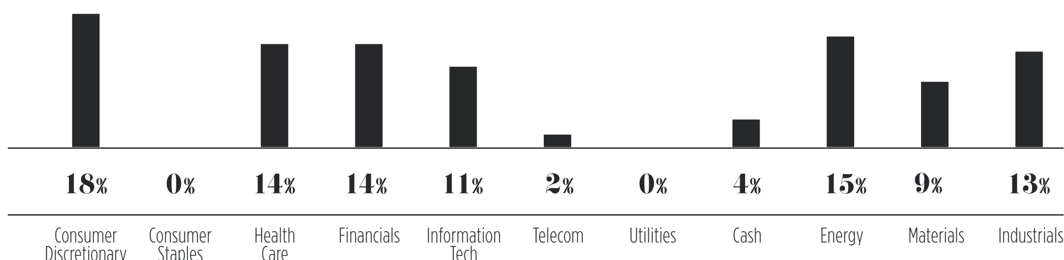
TOP 10 HOLDINGS

1. Transocean Ltd.
2. Cliffs Natural Res 6.25% Due 10-01-40
3. Qualcomm Inc.
4. Brunswick Corporation
5. Bombardier, Inc, cl B
6. New York Times cl A
7. Amgen Inc.
8. Cheniere Energy Partners LP
9. Eli Lilly & Co.
10. American Express Co.

—As of 6/30/18—

*see notes on pg 4 for additional details

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.

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.

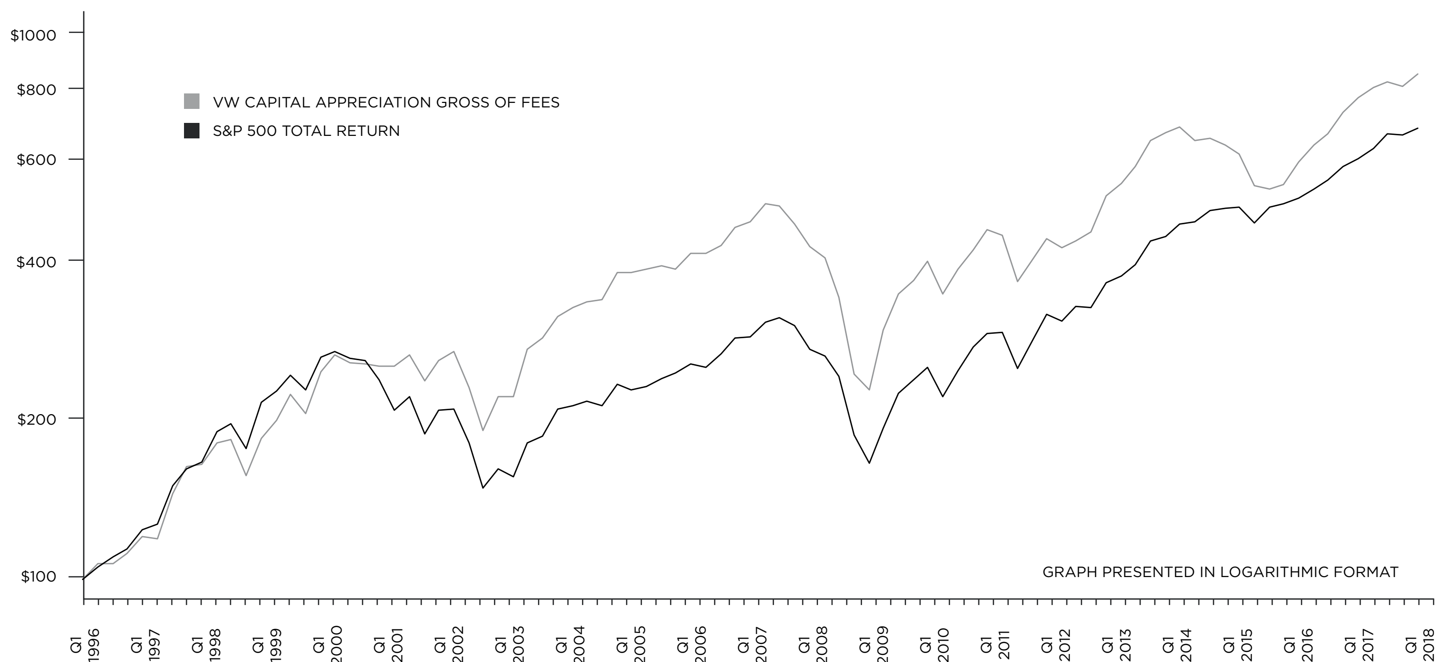
Objective

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.

VALUEWORKS

PERFORMANCE REVIEW

SECOND QUARTER 2018 March 31, 2018—June 30, 2018



TRAILING PERFORMANCE DATA

VALUEWORKS' CAPITAL APPRECIATION COMPOSITE

	GROSS OF FEES	NET OF FEES	S&P 500 TR
2018 Q2	5.34	5.05	3.18
2018 YTD	3.19	2.62	2.39
1 year	10.50	9.26	14.09
3 years	11.89	10.58	11.85
5 years	9.59	8.29	13.37
10 years	8.03	6.68	10.11
Life*	9.93	8.36	8.84

*Life is 22.5 years (inception 1/1/1996)

VALUEWORKS' BALANCED COMPOSITE

	GROSS OF FEES	NET OF FEES	BLENDED INDEX*
2018 Q2	4.78	4.44	1.51
2018 YTD	2.42	1.75	0.38
1 year	8.18	6.77	6.68
3 years	10.11	8.65	6.79
5 years	8.89	7.42	7.59
10 years	7.96	6.46	7.24
Life*	10.18	8.48	7.28

*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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