VALUEWORKS
QUALITY ASSETS COMPELLING VALUATIONS

VOLUME 17,3 THIRD QUARTER 2019

The equity markets and our portfolios posted robust gains through the first nine months of 2019. And that is good. Our Capital Appreciation composite added 13.9% during that period (gross of fees – see p. 6 for additional performance information); the S&P500 was up 20.6% for this same span. But the advance is misleading given its measurement from so close to the bottom of last year's fourth quarter sell-off. Over the past twelve months the markets are much closer to break-even. More than that, investors have earned thin returns over almost a two-year period.

Specifically, the Wilshire 5000 – the broadest popular measure of all US equites—reached 30,400 on August 28th, 2018. It closed the third quarter of 2019 at 30,351. Twenty-one months ago, in January of 2018, it traded to 29,761. While it is true that the indices are within a couple of percentage points of all-time highs, and that the averages have posted one of the best first-three-quarter advances in twenty years, investors in US equities are pretty close to break-even over almost two years.

It is a challenging juncture because on the one hand the fundamentals of the US economy are generally solid, overall valuations are fair, and many specific equities are offering very compelling valuations. On the other hand, the psychological factors weighing on the markets are—and can be expected to remain—particularly daunting.

For us the starting place for the economy is always jobs and interest rates. On the jobs front we continue to add +/-200,000 jobs per month, wage growth is at healthy levels and productivity is within reasonable bands. Unemployment is at multi-decade lows. This is a momentum that builds on itself. As for interest rates, the ten-year treasury bond today trades with a 1.65% yield. A year ago today it was above 3%. That difference has a meaningful impact on economic activity, and we are seeing its effect on real conditions. Housing starts are hitting multi-year highs and given that consumer savings rates are also at 15+ year highs, there is plenty of room for them to go higher. This ten-year expansion has legs because we laid a very

solid foundation in the cleansing cycle of the financial crisis, where so much excess was purged from the system.

That said, the intangibles are profound. The period leading up to a presidential election is always tricky. But between 1984 and 2016 the hard policy distinctions between the parties was subtle. Not 2020. For the first time in a long time, there is a quantum difference in policy approaches between credible candidates. That is going to be a tough reality for the markets to work through. On top of that there is the nature of the impeachment efforts. Week in and week out for as far as the eye can see we can expect to wake up to more stories and hearings arguing whether or not there was criminal activity and/or treason in the White House. Regardless of whether you think it is right or wrong or where you want to lay the blame, this atmosphere does not make for an easy investment climate. Then there are the additional prospects of: an escalating trade conflict; continual riots in Hong Kong; Saudi Arabian oil production being blown up; and the confusion around Brexit.

There is plenty written about the fourth year of a presidential term providing investors with below average returns. But those analyses typically understate the degree of headwind this period creates and mischaracterize the underlying cause of those headwinds. I wrote about this ahead of the last election. It is not simply that there is uncertainty about policy. It is that investors on both sides of the political debate fear the outcome, and therefore no one is confident until they know which way the election will go. Once the outcome becomes clear, half the population breathes a sigh of relief and puts money to work.

Looked at that way, one would expect markets to struggle for some period before the election and then to advance once the results are known. If you measure the calendar year return, you capture the period after the election which includes seven weeks of relief rally.

I've looked at each period from 1984 to now and put together the following table. I looked for (1) the period within 15 months ahead of the election where the market reached a near-term peak, (2) the period where investors seemed confident they knew the election's outcome and where a relief rally started, and (3) the sooner of when the relief rally ended or one year after the election.

TOP 10 HOLDINGS

1. Qualcomm
2. Comcast cl A
3. Cliffs Natural Res 6.25% Due 10-01-40
4. Goldman Sachs Group
5. Apple
6. Amgen
7. Corning
8. Spirit AeroSystems Holdings
9. Brunswick Corporation
10. Kulicke & Soffa Industries

—As of 9/30/19—

*see notes on pg 4 for additional details

S&P 500: PRE AND POST ELECTION TRENDS

MARKET STALL		ELECTION TROUGH		POST ELECTION RELIEF RALLY		FROM STALL TO TROUGH		POST ELECTION ADVANCE	
DATE	LEVEL	DATE	LEVEL	DATE	LEVEL	%CHANGE	# OF DAYS	%CHANGE	# OF DAYS
10/10/83	175	07/30/84	150	11/16/85	198	-14.3%	294	32%	474
10/02/87	320	11/16/88	266	09/30/90	360	-16.9%	411	35%	328
01/02/92	420	10/09/92	400	11/14/93	463	-4.8%	281	16%	401
02/13/96	656	10/28/96	704	10/09/97	980	7.3%	258	39%	346
03/24/00	1,525	12/20/00	1,261	01/30/01	1,388	-17.3%	271	10%	41
01/26/04	1,150	10/25/04	1,090	08/03/05	1,233	-5.2%	273	13%	282
10/09/07	1,571	11/20/08	747	11/10/09	1,100	-52.5%	408	47%	355
03/22/12	1,410	11/14/12	1,350	11/09/13	1,788	-4.3%	237	32%	360
08/27/15	2,097	11/04/16	2,085	11/08/17	2,600	-0.6%	435	25%	369

Meanwhile we know the market climbs a wall of fear. While this may not be maximum pessimism right now, it feels close. If so, any surprises can be on the upside.

In 1984 the trough was reached in the summer before the election. The outcome was pretty clear at that point. In 2000 it didn't happen until December, but of course the outcome was not known on election-day. The only year in which there was not an extended period of decline was 1996. That was in the middle of a massive bull market and the advance was modest to the election result and then we popped 40% to the upside.

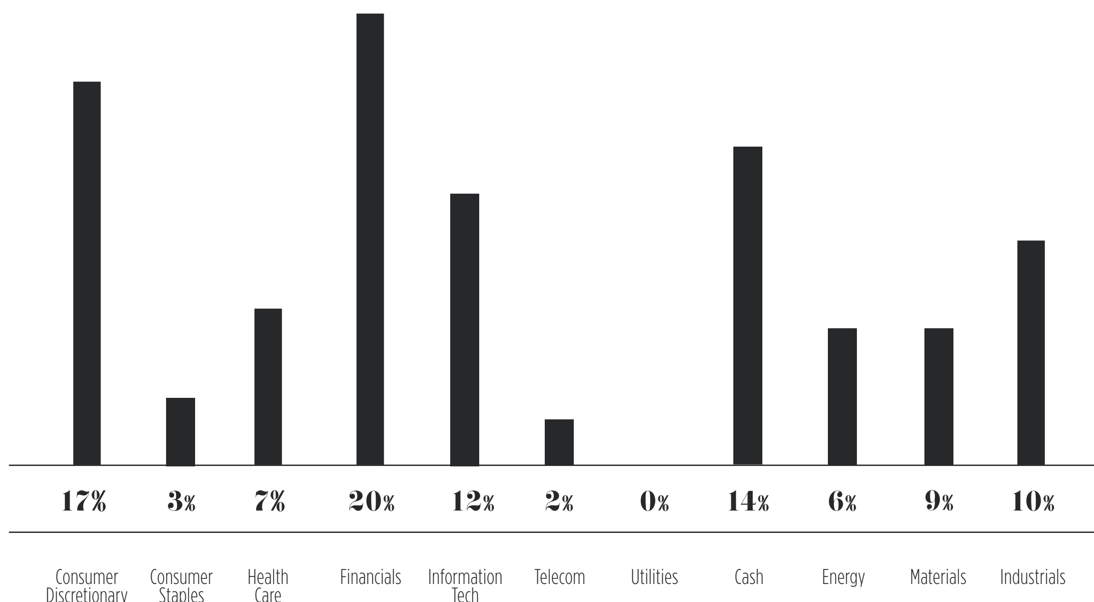
All the negative sentiment in those earlier periods is present today and its translating into some very attractive fundamental opportunities. Our portfolio is stocked with a wide array of them. Our last purchase was Mohawk Industries. Over the past 25 years the company has grown from a mid-quality, roll-up carpet company to, in my estimation, the best positioned, best managed and highest quality stand-alone global flooring company. The company has had some near-term execution issues, some changing industry dynamics around technological change and consumer preferences (LVT is a compelling alternative and comes at a lower price point) and macro headwinds. But the shares are down 60% from their highs to trade at 6.5 times EBITDA and ten times challenged earnings. Looking out two to three years I am confident the company will earn over $15 per share and trade at better than 15 times earnings, for over a double in the share price. If one needs to hang their hat on what will happen in the next two quarters to the share price, you have no basis for a decision. If one is willing to look past that horizon, the conclusion is obvious. The same analysis can be applied to 25 other investments in our portfolios.

Meanwhile we know the market climbs a wall of fear. While this may not be maximum pessimism right now, it feels close. If so, any surprises can be on the upside. Surely if there are positive developments on any of those issues identified above, they will seem to come out of the blue and could torque equities higher. Given that we have already been through a nearly two-year period of stagnant returns, and given that the economy is actually performing reasonably well, I see more risk in being underinvested than in being overinvested.

-Charles Lemonides, CFA

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*

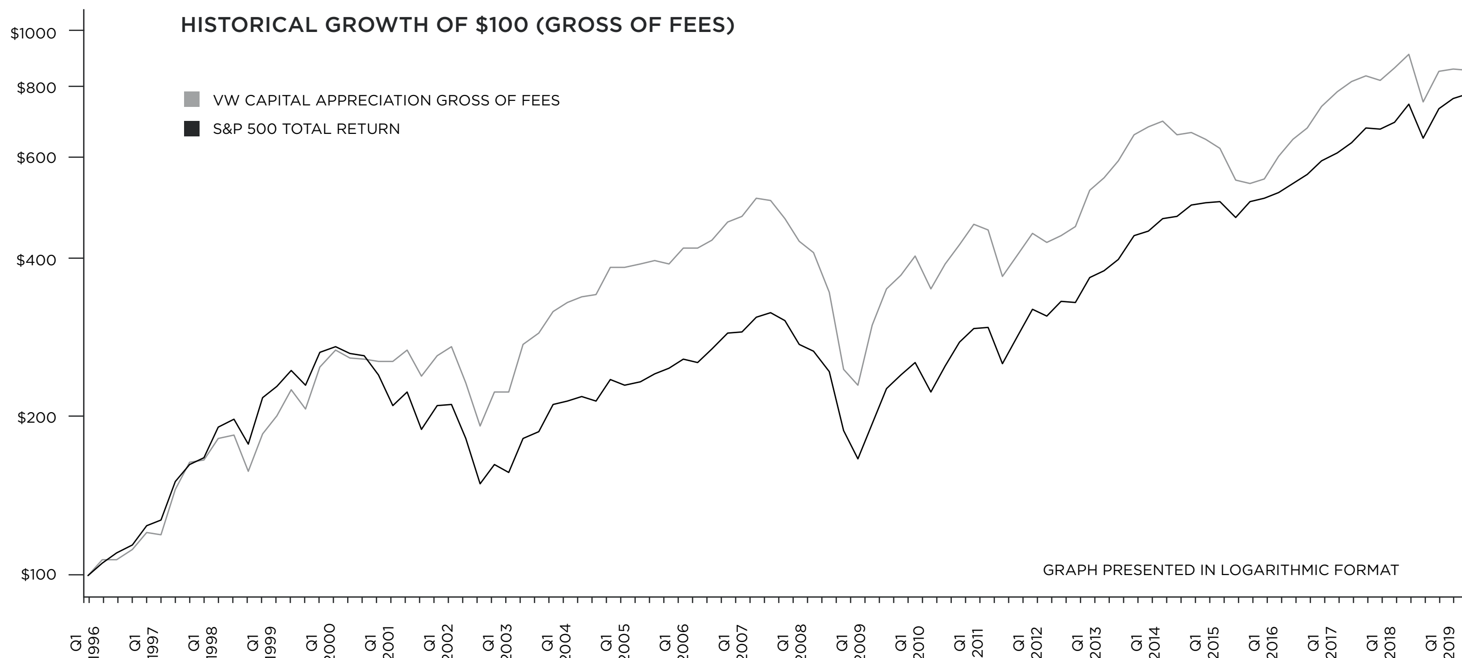
We exit a position when a security either reaches full valuation or changes in its outlook invalidate part of our original thesis.

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 THIRD QUARTER 2019 JUNE 30, 2019—SEPTEMBER 30, 2019



TRAILING PERFORMANCE DATA

VALUEWORKS' CAPITAL APPRECIATION COMPOSITE

	GROSS OF FEES	NET OF FEES	S&P 500 TR
2019 Q3	-0.53	-0.80	1.70
2019 YTD	13.88	12.94	20.56
1 year	-6.65	-7.70	4.26
3 years	10.08	8.83	13.31
5 years	5.55	4.32	10.79
10 years	9.60	8.26	13.19
Life*	9.34	7.80	8.88

*Life is 23.75 years (inception 1/1/1996)

VALUEWORKS' BALANCED COMPOSITE

	GROSS OF FEES	NET OF FEES	BLENDED INDEX*
2019 Q3	1.29	1.01	2.05
2019 YTD	14.50	13.18	14.69
1 year	-4.23	-5.64	7.88
3 years	8.22	6.75	8.28
5 years	5.10	3.66	7.25
10 years	8.95	7.44	8.61
Life*	9.65	7.97	7.40

*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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