

# ValueWorks:

Redefining wealth management through critical thinking and independent research

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## Remembering the Objective: Staying Focused On Results

In a normal year, the fourth quarter's rally would look impressive. But after the declines suffered through September, an 8-10% rally—on an emotional level—seems almost inconsequential. 2002 turned out to be the broadest and deepest decline yet seen in this three-year bear market. The Nasdaq 100 paced the decline, with a loss of 38% for the year, the Nasdaq composite eroded by 31%, and the S&P 500 lost 22%, matching the average diversified mutual fund loss of 22%. The Dow held up the best, with a decline of 15%.

Our Capital Appreciation and Balanced composites posted gains of 15.5% and 13.1% respectively in the fourth quarter, to end the year with declines of 13.9% and 12.5%. Over the past seven years – the life of our composites – we have posted cumulative gains of 117% and 126%, and annualized gains of 11.7% and 12.3% (for Capital Appreciation and Balanced respectively).\* By comparison, the S&P over the same period posted a cumulative gain of 59%, or 6.8% annualized.

These seven years have offered a wide array of challenges for investors; I believe the underlying key to our success in meeting those challenges has been the real diversification in our portfolios – which is itself a function of the robustness of our investment discipline.

### ValueWorks' Top 10 holdings:

1. **Fidelity National Financial**
2. **Pfizer**
3. **Rowan Companies**
4. **Washington Mutual**
5. **Cablevision 11.75% pfd**
6. **Level 3 bonds 9.125% of 05-'08**
7. **Conexant Systems 4% bonds of 02-'07**
8. **Sprint**
9. **Disney**
10. **JP Morgan Chase --as of 12/31/02--**  
see notes on p4 for additional information

Emotionally, the rallies of the recent fourth quarter are likely to seem inconsequential until much of the downturn has been made-up. Economically though, the rebound period—which I believe we are in—is when the greatest advantage is to be realized. Because valuations are depressed, we are quite well invested. We have been adding exposure on the way down, as opposed to the later stages of a bull market, when we should be scaling positions back. Given our greater exposure, we should benefit more from a 30% market advance off the bottom than we should from the last 30% rise to a market top. Also, were the S&P to recoup half of its current decline by the end of 2003, ending the year at 1210, commentators will be quick to label that a loss of 20% over a disheartening four-year period. While they would be correct, it would also represent a 30% gain from current levels. For us, capturing that kind of growth in the near term would increase our portfolios to an extent that would significantly magnify any subsequent gains.

\*These figures are gross of fees: for additional information on returns, including net performance, see the chart at the bottom of page 4 and the accompanying footnote.

All that said, these are quite unsettled times. We face real-world challenges that may or may not be managed well. These challenges are varied and complex, and are not necessarily given to clear, straightforward resolution. The problems are as varied as regulatory disasters in telecommunications and energy markets, to a "crisis in corporate governance," to a general strike in Venezuela, to international terrorism, to "rogue states" like Iraq and North Korea.

Clearly, the decisions and actions of policy makers will determine how these challenges are resolved. The right steps could remove major market concerns, and substantially improve both the economic and market outlook. But bad decisions that result in continued upheaval and further deterioration remain real risks. Given these concerns and risks, we are defensively diversified. Important diversification has always been a distinguishing trait of our portfolios. We are spread not only among securities – as all decent portfolios are – but also across a wide and well-considered spectrum of security types and industries.

The unifying element across all our holdings is price – I believe each holding is an attractively valued claim against valuable assets. But the types of claims and the types of assets are highly varied. The title insurance companies and financial services companies we own should benefit from continued low interest rates and negligible inflation. Our energy exposure should

provide some lift if conditions in the Middle East become increasingly heated. Our pharmaceutical exposure, historically considered rather defensive, could perform quite well as earnings grow steadily and multiples expand. Our media and basic industrial exposure should benefit from modest economic growth, while our technology and telecommunications exposure is well positioned for a cyclical rebound. These are truly eclectic, diversified portfolios, built to withstand market turmoil, yet provide upside as that turmoil subsides.

Organizationally, ValueWorks continued to grow through this challenging year. Gerry Fahey joined us in July. I worked with Gerry at Gruntal & Co. almost ten years ago, where he helped craft the Professional Asset Management department. He joined us from John Levin & Co., a \$13 billion value-oriented investment advisory firm. His MBA is from Fordham University (go Rams). In August Eric Tucker joined us after a five-year stint in with Goldman Sachs. He is a Fulbright Scholar with a Masters degree in International Affairs from Columbia University (go Lions? – we're not sure). Both are motivated by a desire to build upon their investment skills and to help grow a firm built on a value-investment discipline and a culture that prizes critical thinking and independent research.

Charles Lemonides, CFA

*“We control  
quality  
assets at  
compelling  
valuations”*

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### **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 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.

### **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:

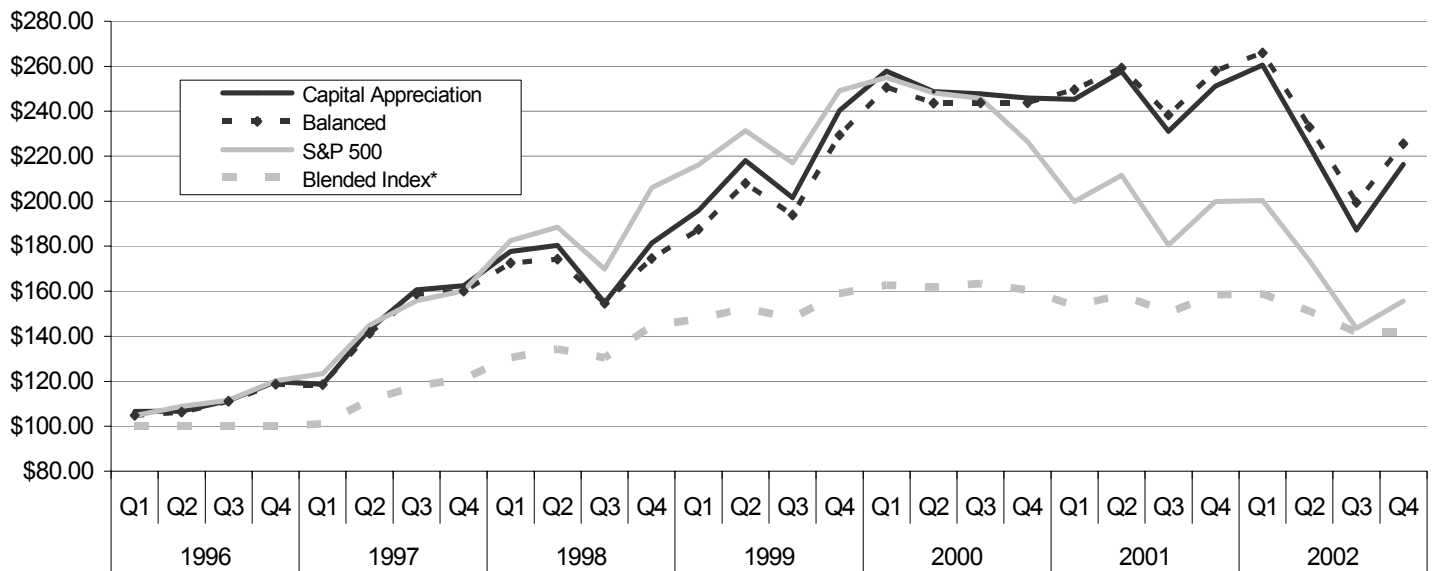
- Individual review of your portfolio requirements
- A separately tailored portfolio created and maintained to your investment objectives and risk tolerance
- Access to the Portfolio Manager on an ongoing basis with timely and responsive communication
- Flexibility to meet your changing tax requirements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

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

# ValueWorks: Performance Review

4<sup>th</sup> Quarter—December 31, 2002

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



## 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*
<b>Rolling 7 Year Return</b>	11.72%	9.84%	6.54%	12.33%	10.59%	7.53%
<b>Rolling 5 Year Return</b>	5.89%	4.26%	-0.58%	7.11%	5.55%	4.19%
<b>Rolling 3 Year Return</b>	-3.45%	-4.86%	-14.50%	-0.55%	-1.73%	-2.19%
<b>Rolling 1 Year Return</b>	-13.89%	-15.12%	-22.08%	-12.54%	-14.05%	-6.17%

\*The 'blended index' is 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 quarter under management. Exiting accounts are included through the last full quarter under management.

"Top 10 Holdings" are compiled from the aggregate holdings of the ValueWorks' Capital Appreciation Composite. Neither this or any other reference to specific securities in this publication is intended to be a recommendation to purchase or sell these or any other securities.

The Capital Appreciation Composite consisted of 53 accounts and \$31,260,254 in assets as of 12/31/02; the Balanced Composite consisted of 62 accounts and \$32,364,645 in assets as of 12/31/02. Combined, these represent over 99% of the accounts, and approximately 86% of the assets managed by ValueWorks LLC. These results were generated at other firms prior to the fourth quarter of 2001. Results for other composites are available upon request.

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