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ValueWorks:

Redefining wealth management through critical thinking and independent research

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An Important Crossroads . . .

The markets remain lackluster for the quarter and the year. The S&P 500, Dow Industrials, and Nasdaq Composite returns for the quarter were: down -1.8%, down -2.9%, and down -7.2%. For the year-to-date the respective numbers are: up 1.5%, down –2.1%, and down -4.9%.

By contrast, our ValueWorks composites are all in positive territory. Our Capital Appreciation composite was up 0.7% in the third quarter — for a 7.29% return year-to-date.*

As expressed in our January letter, earning returns this year has been hard work. This could change for the better if business investment improves, translating to higher economic growth and job growth—thus melting the investment sclerosis of the past four years. While the ingredients for that investment are there, I see little anecdotal or empirical evidence it is occurring. Failing such a transition, careful security selection, prudent sector weighting, and disciplined portfolio management may remain the keys to generating fair returns over the near term.

Massive fiscal and monetary stimuli have buoyed demand through the past four years. But those stimuli have not translated to job creation and higher investment in order to meet that demand. As a result, we are beginning to see conditions that mirror the stagflation we lived through in the mid-late 1970's, following the last great bear market.

ValueWorks' Top 10 holdings*:

1. **Apple Computer**
2. **Pfizer Inc.**
3. **Wachovia Corp**
4. **Calpine bonds 8 ½ of 2011**
5. **Sprint Corp**
6. **Freddie Mac**
7. **Rowan Companies Inc.**
8. **Sun Microsystems Inc.**
9. **Sony Corp. ADR**
10. **Baxter International**

—as of 09/30/04—

*see notes on p4 for additional information

An investment boom (or at least solid upturn) could still be around the corner. This would be consistent with the classic business cycle that I have been talking about throughout this market cycle. However, this financial and economic downturn has in fact been much deeper and more damaging than I believed conditions warranted. And there is no real evidence of such activity in progress. So I am unwilling to accept on faith that it is just around the corner.

Presently, there seems to be a hesitance on the part of businesses to build productive capacity to meet higher demand that seems inconsistent with a smoothly functioning system. This is not something I would have predicted given my expectation of a normal business cycle.

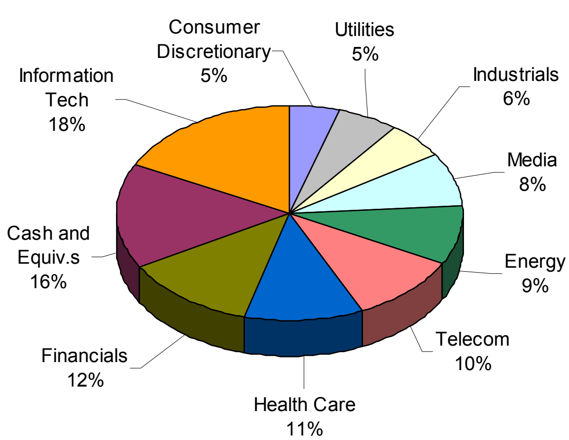
Consequently, we are seeing production bottlenecks that are translating to higher prices (as well as higher corporate earnings and very high profit margins). But these bottlenecks are not leading to increased investment, increased employment and higher industrial capacity. Given that we have expended virtually all the monetary and fiscal tools we can muster to respond to the downturn, it would be concerning should that investment not begin to show up.

*ValueWorks figures are gross of fees. For additional information on returns, including net performance, see page 4.

Three necessary ingredients for higher invest-ment are in place. First, there is ample demand for output. Second, prices are high enough that those investing in productive capacity can earn a return on their investment. And third, those in a position to build new capacity appear to have the financial wherewithal to do so. Yet that investment at this point seems to be timid.

I cite the following examples: Oil is at $50 a barrel and natural gas is at $6 per mcf. While that may be a challenge for the rest of the economy, it should be a boon for the energy sector. One would expect the oil patch to be on fire with every rig working. Activity is up, but there are oil rigs (both offshore and land rigs) that are not yet working. And while the price charged by rig operators is plenty higher, there is scant activity building new rigs. As a result, demand for energy is still growing faster than the capacity to meet it (with OPEC producing virtually at its capacity), yet companies are not investing what they could in order to build capacity either in drilling wells or in building rigs to drill those wells. Even oil service companies are not benefiting as reflected by the OSX index of oil service stocks being lower today than it was four years ago.

Sector Diversification (Capital Appreciation)



Similarly, oil tankers are minting money. Every tanker is being used. But the invest-ment in building new ones is not being seen in the US economy, and hardly seems to be at the feverish pace one would expect.

In the transportation sector, Union Pacific is again seeing bottlenecks on its freight lines, is charging higher prices, and is literally having to turn away customers. But capital invest-ments in its first half of this year totaled $857 million versus $863 million last year. Steel prices have reached the moon and seem to be heading higher. But Nucor, which saw revenues advance 82% and realized 61% higher steel prices this year over last, has invested all of $111 million in capital expenditures in the first half. While this was higher than the $95 million spent in 2003, it remains lower than depreciation of $193 million, and well below the $415 million they spent in the full year 2000. For the first half US Steel's revenue advanced from $3.7 billion to $5.9 billion. Capital expenditures advanced from $132 million to $165 million. These investments are timid.

For each of these companies, balance sheets are solid and money is available at less than 6% interest. Yet they are not making the investments and they are not hiring the people. The number of people working today is lower than it was four years ago. And we are seeing this translated in very difficult financial markets. Were the pattern to break, we could be looking at a very robust 2005. I am comfortable our portfolios will participate quite well. If not, I believe we will need to remain very disciplined and focused in order to continue earning fair returns through a challenging environment.

--Charles Lemonides CFA

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ValueWorks:

controlling quality assets at compelling valuations

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 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

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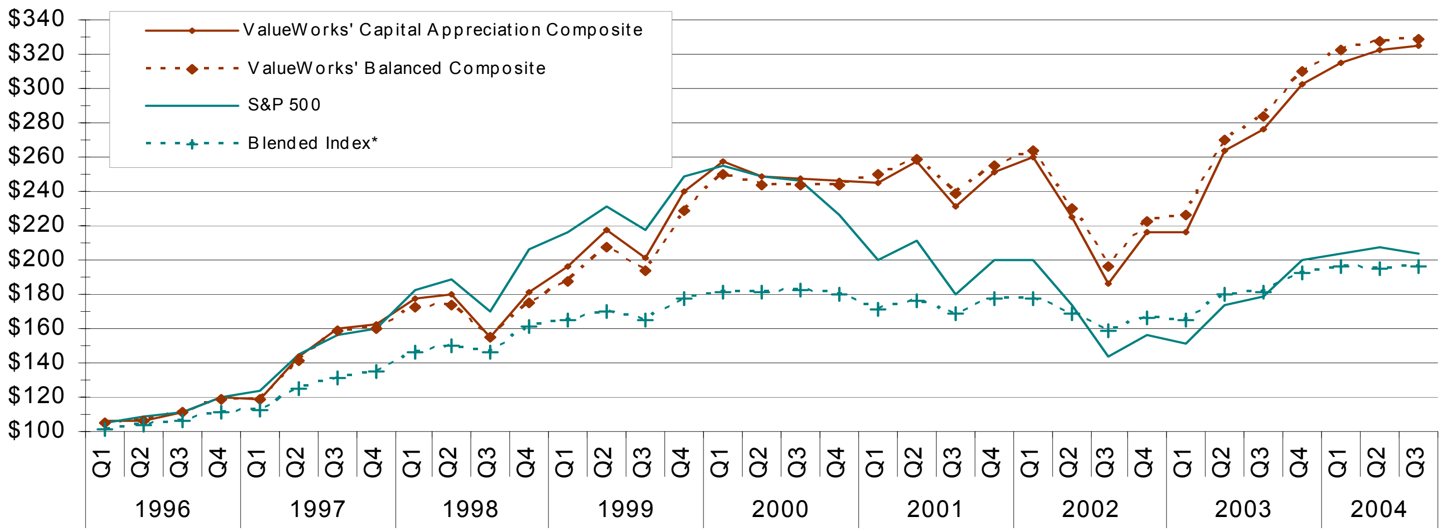
3rd Quarter: June 30—September 30, 2004

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*
Return 1996 - Present	**14.41**	**12.53**	**8.46**	**14.57**	**12.58**	8.04
Rolling 5 Year Return	10.02	8.42	-1.29	11.14	9.26	3.53
Rolling 3 Year Return	12.03	10.43	4.05	11.34	9.49	5.37
Rolling 1 Year Return	17.82	16.19	13.82	15.96	14.20	8.23
2004 YTD Return	7.29	6.19	1.49	6.07	4.88	2.49
Q3 Return	0.70	0.35	-1.88	0.48	0.13	0.67

*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 month under management. Exiting accounts are included through the last full month under management.

"Top 10 Holdings" are complied from the aggregate holdings of the ValueWorks' Capital Appreciation Composite. Neither this nor 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 149 accounts and $66,808,262 in assets as of 9/30/03: the Balanced Composite consisted of 94 accounts and $55,963,183 in assets as of 9/30/03. Combined, these represent over 99% of the accounts, and approximately 90% 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.