

Since mid-January, unexpected and exuberant rallies have offset the impact of slow, tormenting declines. The year began with a quick ten percent air pocket in the first three weeks, dropping the indices almost twenty percent from the October highs. But from that point forward, bad economic news and negative market sentiment have not translated into further declines. Despite increased perceptions of dismal market action, heightened investor pessimism, and dramatic day-to-day volatility, the reality is that the markets have held their own for almost three months.

Still, the decline in those first few weeks of the year and consequently the quarter was deep and broad-based. The S&P 500 declined by -10.3%, the Dow Industrials by -7.8%, and the Nasdaq Composite by -14.6%. Smaller capitalization shares fared no better, with the Russell 2000 index off by -10.6%. Both growth and value investors participated in the downturn. The average large cap growth mutual fund declined by -11.0% while the average large cap value fund posted a “better” -8.3% decline, as measured by Morningstar.

While the drop was steep, it is important to be aware of how dramatic the rebound from these sell-offs can be. As of this writing, which is in the first month of the second quarter, our portfolios have recouped roughly half of the first quarter’s decline.

## ValueWorks’ Top 10 holdings\*\*:

1. Cypress Semiconductor Corp
2. Chesapeake Energy Corp
3. Rowan Companies Inc
4. Questar Corp
5. New York Times
6. Boeing Company
7. 3m Company
8. Dow Chemical Company
9. Pfizer Inc
10. Boston Scientific Corp

—as of 03/31/08—

\*\*see notes on p4 for additional information

This market action is consistent with an economy that has entered - or is teetering on the brink of - a recession. However, because I view the slowdown as broadly caused by restrictive macro-economic policies, and because those policies have now been completely reversed, I expect a corresponding reversal of the economic and market decline.

Restrictive policy actions were designed to take the froth out of housing prices and financial markets. The advance in home prices and the leverage that had entered the financial system were unsustainable. Restrictive policy measures put in place to contain those excesses represented a reasonable response. However, if the current situation is a problematic “crisis”, then it occurred simply because the restrictive policies were kept in place too long and went too far. Reversing these policies sooner would have lessened the near-term economic damage. Rather than engineer a slowdown, these policies led to something much closer to a melt-down.

The extreme turmoil in the credit markets has occurred because – until recently - policy makers’ actions to contain and reverse the liquidity drain have been too timid to be effective. This crisis did not occur because it was destined to, nor because policy makers lack the tools to contain it, but rather because they chose to use those tools at a more modest, measured pace.

Since Mid-March, policy makers have become more aggressive. Both the Federal Government and the Federal Reserve Bank are now using all the tools available to clear the logjam in the financial markets. Those measures should have the intended outcome – creating liquidity in the financial system and restarting economic growth. Consequently, I expect those investors whose portfolios remain largely intact, and who have maintained their investment exposure, will realize significant advances in the near term. When investor perceptions change from recession to economic expansion, the market advance tends to be quite dramatic.

Looking past such an expected rebound, I think it is unclear that the longer period of lackluster returns is completely behind us. These are not the same prosperous times that led to a general market advance from 1981 to 2000. Both the markets and the economy face non-liquidity based challenges. We are now in the longest period of unchanged market indices since the 1970s. (The S&P 500 traded at 1,275 in both January of 1999 and March of 2008 – the Nasdaq traded at 2,200 in both periods.) This stagnation can be attributed to a number of specific causes, many of which are ongoing. Whether an advance off these levels morphs into a meaningful long term trend will depend upon how those broader economic issues are resolved.

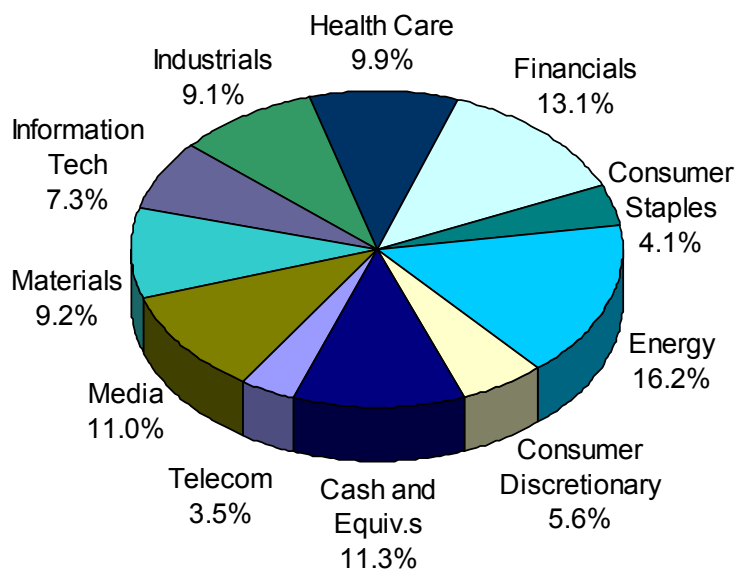
That said, we earn our keep as investors during these more challenging periods. During economic prosperity and broad market advances, churning out positive returns is not challenging. Navigating the more tumultuous period since 1999 is much tougher. During this period we distinguish ourselves not because our portfolios have completely avoided declines. Rather, the portfolios have done well over time because we have built on our exposure during declines, positioning ourselves to exploit the

subsequent rebounds. Our confidence in our investment discipline – owning quality assets at attractive valuations – has enabled us to use market volatility to build diversified portfolios comprised of attractively priced, quality securities. That has clearly been an important element in our ability to earn investors healthy returns over this extended period of overall market flatness.

We have continued to do the same through this decline, adding to our exposure as the market decline accelerated, with our last major purchases right around the market lows in January. At this point I consider our portfolios as chock-full of high quality, attractively priced securities as any time since the market trough in 2002/03.

—Charles Lemonides, CFA

**Sector Diversification--  
Capital Appreciation Composite\***



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# ValueWorks

critical thinking. independent research.

## **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 overdiversi-

fication. 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:

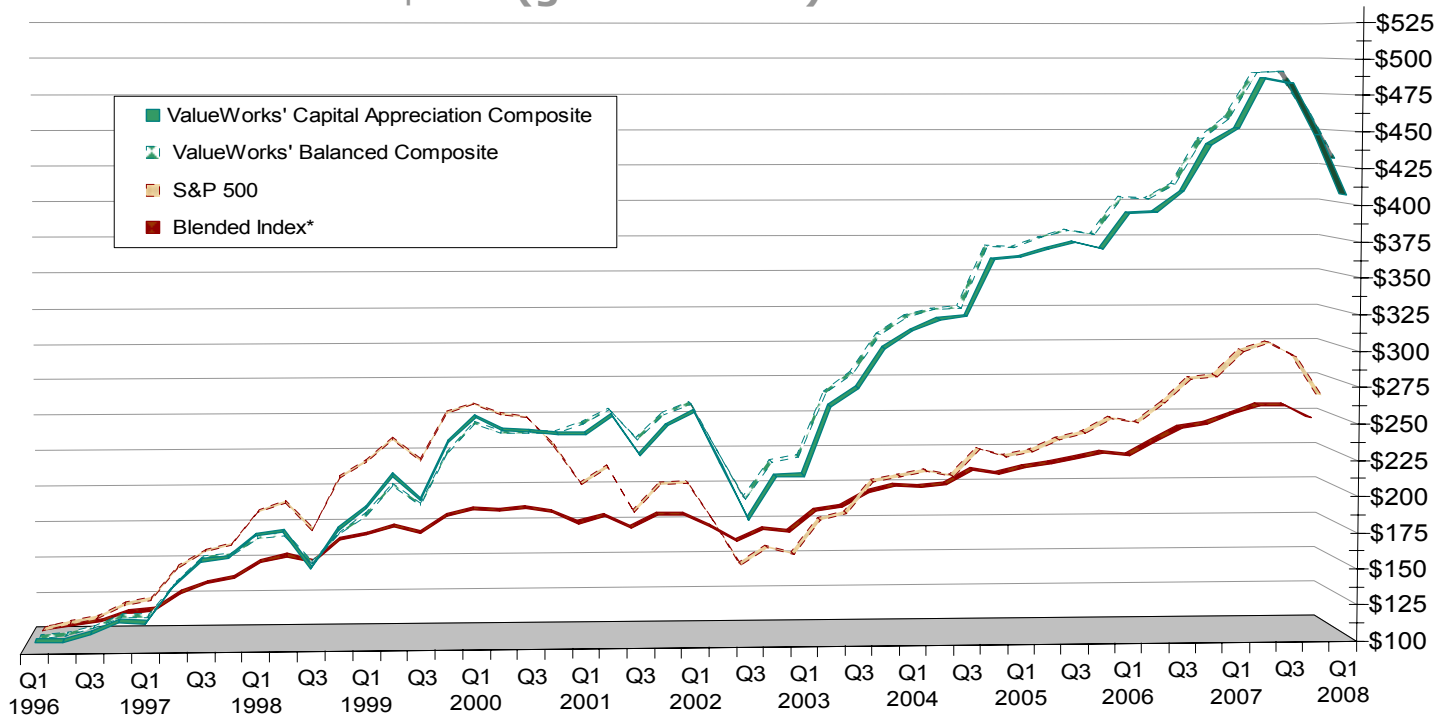
- Individual review of your portfolio requirements
- A separately tailored portfolio created and maintained to your investment objectives and risk tolerance
- Access to the Portfolio Manager on an ongoing basis with timely and responsive communication
- Flexibility to meet your changing tax requirements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

**1st Quarter: December 31, 2007 – March 31, 2008**

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



## Trailing 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*
10 year	8.64	7.08	3.52	9.59	7.81	5.21
7 year	7.49	6.03	3.72	8.13	6.47	5.07
5 year	13.50	11.98	11.33	13.78	12.13	8.04
3 year	3.70	2.30	5.88	5.18	3.61	5.92
1 year	-10.13	-11.28	-5.08	-6.10	-7.50	1.66

\*The "Blended Index" is a calculation comprised of 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 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 pe-

As of 3/31/2008 the Capital Appreciation Composite consisted of 504 accounts and \$155,808,219 in assets; while the Balanced Composite consisted of 125 accounts and \$67,975,864 in assets. Together this represents 99.53% of total accounts and 85.63% of total assets.

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