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ValueWorks

quality assets. compelling valuations.

Volume 7,3 **Q1 2009**

We are six quarters into a market decline. Despite a sharp rally from early March, the S&P declined a further 11.0% in the first quarter while the Dow Industrials declined by 12.5% and the Russell Value index shed 16.7%. The Capital Appreciation composite performed relatively well in this context with a decline of only 6.6%.

Our focus is on managing the portfolios to not only weather this financial maelstrom but, over the cycle, to benefit from the upheaval. This strategy has two key components. First, we are focusing our holdings on companies that are themselves, for a variety of reasons, poised to benefit from this upheaval. Second, we are exploiting investment opportunities that are distinctly available during periods of such turmoil. We, unlike managers who are predominantly "waiting for the markets to come back," have been more active than usual during this decline, making changes to adapt to — and ultimately exploit — current conditions.

I am avoiding the self-indulgent tendency of many managers to rehash how deep the downturn has been and bemoan how long it will or will not last. Still, it is important to recognize that even though these are clearly bad economic times, there are some meaningful positives within this overall negative environment. Also, as I have pointed out time and again over the years, economic and market conditions tend to change much faster than seems credible at any given point in time. The present six-quarter market decline *feels* like an investment eon. Looking back six-quarters from now, I expect this maelstrom will *feel* similarly distant.

The challenge is not to predict how deep the decline will be or how long it may last, but rather to manage the portfolio so that it is in better shape after the financial storm has passed than it was before the storm started. For us, a good starting place is making sure the core of the portfolio is invested in companies that are poised to not only survive, but to emerge in even stronger competitive positions.

To this end, we've been building the portfolios around a core of stable companies that are positioned to do just that. Holdings like 3M, Boeing, Micron Technologies, Teco Energy, McGraw Hill, Boston Scientific, and Zimmer Holdings represent some of the better managed names in their respective sectors and hold dominant and entrenched competitive positions sustained by massive barriers to entry. And in more aggressive or leveraged names we have exploited opportunities to move higher in the capital structure – swapping out of stocks and buying debt or preferred shares -- creating better upside even in the context of lower overall valuations.

Further, many of our portfolio holdings are actively taking advantage of opportunities afforded by the current environment through acquisitions, strategic partnerships, and corporate restructuring. Companies holding and/or generating cash are out shopping for business and asset bargains. Pfizer's recently announced acquisition of Wyeth affords access to Wyeth's vaccines, consumer products and experimental biotechnology treatments at an attractive price. Savvy negotiating can also accomplish much as Chesapeake Energy demonstrated by engineering a number of strategic partnership to provide continued drilling in key plays despite today's low gas prices. While other natural gas companies have drastically cut capital expenditures, Chesapeake has been able to position itself so that its partners will fund drilling programs over the next few years, which should make its reserve replacement ratio superior to its competitors.

Just as companies like Pfizer and Chesapeake have been able to exploit current economic conditions to their advantage, we also have used this environment to our advantage in several ways. Our portfolios will be better off in the long run as we carefully select from the vast array of compelling investment opportunities offered in current markets.

Our portfolio activity has been greater in the last year and a half than in the several years prior. For one thing, greater volatility has allowed us to enter and exit investments more quickly than during periods of relative market stability. Moreover, panicked investors indiscriminately fleeing to cash have left share prices seemingly divorced from economic reality and value, creating potentially dramatic opportunities. Although we have scaled back several of our positions when we felt that they had become fairly valued, we have been net buyers during this period.

Top 10 holdings*:

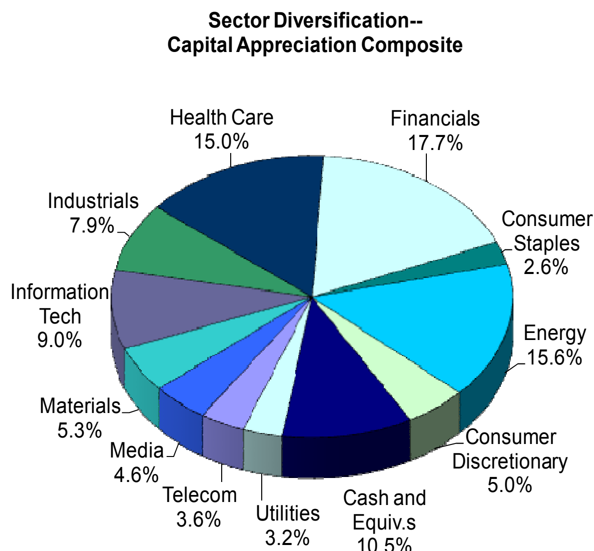
1. 3m Company
2. Constellation Energy Pfd
3. Boston Scientific
4. Pfizer Inc
5. Questar Corp
6. Bank of America PFD
7. McGraw Hill
8. Micron Technology
9. Boeing Company
10. Zimmer Holdings

—as of 03/31/09—

*see notes on p4 for additional Information

Of note, this environment has offered us uncommon opportunities to acquire senior instruments with considerable yields. Bank preferreds in particular have been trading at deep discounts across the board. This may in part be because investors are more fearful than rational in this sector. But, the fact that a certain skill and experience set is required to evaluate risk in these instruments does give professional investors of a certain bent a distinct advantage. Wells Fargo and Bank of America, two institutions that I expect to be among the survivors in this battered sector, have preferreds trading at yields between 12% and 20%. These yields can come down just as quickly as they went up as shares move towards par offering us a superb opportunity for meaningful appreciation along with attractive income.

Lastly, while the majority of our holdings are large stable companies with relative low risk, we have also used this environment to build exposure to more aggressive names offering larger upside potential. And we have typically done this in senior securities where our expertise in evaluating capital structures may give us a significant advantage. Although this group of investments represents a comparatively small percentage of each portfolio's market value (and we are generally buying smaller positions than usual for us in these higher risk/return profile investments) they are an important component of our overall investment program. Some of these names may not survive, but those that do should, we expect, see large percentage gains more than outweighing possible losses. All told, we have not seen these kinds of investment opportunities for quite some time and in the long run our portfolios may very well end up in a much better position than if this sell-off, distressing as it has been, had not occurred.



It can be a challenge to see beyond the seemingly endless stream of depressing economic news. It is important to recognize though that there have been a number of positive developments during the past quarter. Foremost, the U.S. government has demonstrated its full commitment to reviving stalled financial markets and economic activity through a substantive program of monetary and fiscal stimulus.

We can quibble about the details of the stimulus package and, yes growing deficits are not ideal, but the important task at hand is to rev-up a stalled economy. We are cautiously optimistic that the overall government strategy will achieve this end.

Our financial system, in deep freeze just months ago, is showing signs of a thaw. The credit markets for investment grade companies are functioning with hundreds of billions of dollars worth of debt issued over the past few months at rates between 5 and 6%. While these rates represent a wide spread over Treasuries, they are still low in absolute terms. Some of this debt activity has facilitated the aforementioned M&A activity. On another key front, home affordability is at a record high with softer markets and the 30-year fixed-rate mortgage averaging 4.85% last week - its lowest level since Freddie Mac began tracking rates in 1971. And energy prices have stayed down following the dramatic declines in the latter part of 2008.

Lastly, I would like to expand upon a point that I have made in the past but which seems particularly salient now: the time frame during which periods of economic turmoil play out are generally measured in quarters, not years. Markets move quickly. We saw how rapidly general business conditions deteriorated over the past year and a half. It is entirely plausible that we could see improvements that are equally dramatic within the same time frame.

Reflecting on earlier maelstroms, whether the 1930's or 1970's, the crux is in the investment opportunities that were presented and either acted on or not acted on. Those with the foresight and ability to put money to work generally benefited dramatically. Those who "moved to the sidelines" or waited for less tumultuous times, were scarcely able to recreate those opportunities. So the current debate over how far we are through the current cycle is a distraction. The important thing is that the current turmoil affords substantial investment opportunities. And the companies and investors that are taking advantage of these opportunities will end up in a much better competitive position once the financial maelstrom subsides.

—Charles Lemonides, CFA

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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 overdiversification. 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:

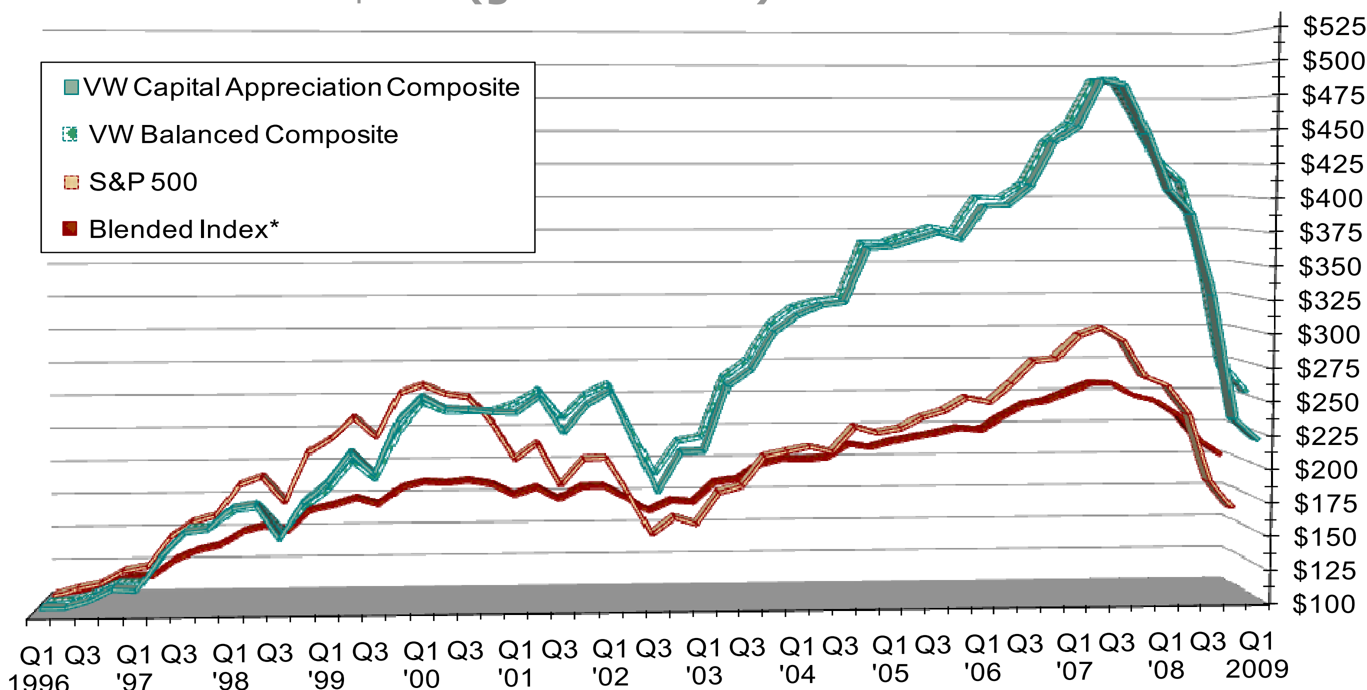
- Individual review of your portfolio requirements
- A separately tailored portfolio created and maintained to your investment objectives and risk tolerance
- Access to the Portfolio Manager on an ongoing basis with timely and responsive communication
- Flexibility to meet your changing tax requirements 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, 2008 —April 31, 2009

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	1.25	-0.19	-2.99	3.11	1.45	1.84
5 year	-6.79	-8.07	-4.76	-4.43	-5.85	0.08
1 year	-45.45	-46.19	-38.12	-40.39	-41.31	-18.78
Q1 2009	-6.58	-6.89	-10.98	-7.08	-7.44	-5.44

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 avail-

As of 3/31/2009 the Capital Appreciation Composite consisted of 264 accounts and $49,011,135 in assets; while the Balanced Composite consisted of 80 accounts and $26,539,856 in assets. Together this represents 99.14% of total accounts and 80.31% of total assets.

Past performance is not a guarantee of future results.