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ValueWorks

quality assets. compelling valuations.

Volume 8,2 **Q4 2010**

Healthy and Happy New Year.

2010 proved productive for investors willing to put money to work. Those with the clarity to commit to equity exposure generated respectable returns for the year. Those who remained in cash on the sidelines did not. The S&P 500 was up 15.1% for the whole year with the Dow close behind at 11.0%. Performance for our Capital Appreciation accounts split the difference and returned 13.7% (gross).

If history is a guide, we can expect the type of market environment that characterized 2010 to extend for the next several years. The recent past has been marked by sharp, erratic near term swings, and modest, sustainable long term gains. This makes sense in the context of an economy that is moving from sharp economic contraction to a period of extended expansion.

I consider the salient lesson of the past decade to be that the business cycle is alive and kicking. The era from 1982-2000 may have lulled us into thinking that the effective use of monetary and fiscal policy would result in more modest business cycle swings; that periods of boom and bust would not be as dramatic as those experienced though the first three quarters of the century. That has not proved to be the case; the swings of the past decade have been quite dramatic.

But this nevertheless appears to be a classic, if deep, business cycle—and one that has transitioned from contraction to expansion. Of course it will take several years before we can get to a really strong economy, and longer still before we reach anything that can be called a boom. But it seems we are well past the worst of the bust. There is ample evidence—from consumer confidence to auto sales to job creation—that conditions are improving. There is also ample evidence that there remains plenty of room for further economic gains.

Central to this understanding is the notion that classic economic tools and policies can comfortably be used to explain the trajectory of economic activity. Just as important, my reading of current policy actions is that they are consistent with creating conditions for continued improvement. Appropriate fiscal stimulus from the Federal Government seems firmly in place with the recently approved tax regime. “Belt-tightening” was exactly the wrong type of reaction that deepened the downturn early in the 1930’s (Before the notion of Keynsian Pump-priming took hold). The risk that the Federal Government would go in the wrong direction and focus on lowering the level of the deficit was surely real, but that appears a much less likely scenario now. I am unequivocally in the camp that advocates the path back to the US fiscal surplus of a decade ago is through an extended period of economic expansion. Emphasis on deficit reduction is highly counterproductive when unemployment levels are close to 10%.

Current expansive monetary policy also seems the clear right choice given the present state of the economy. That said, popular concerns over the really exceptional degree of monetary expansion do warrant examination. In my view, this tremendous expansion of the money supply is needed to keep the economy going because so many of the financing options that were available during the boom period are still not available. Specifically, both the commercial paper market and the asset backed securitization market had been important sources of liquidity pre-2008.

Top 10 holdings*:

1. Corning Inc.
2. Rowan Companies Inc.
3. Williams Companies
4. Calpine Corp.
5. Dow Chemical Company
6. Boeing Company
7. Micron Technology Inc
8. 3M Company
9. McGraw-Hill Companies
10. Legg Mason Inc.

—as of 12/31/10—

*see notes on p4 for additional Information

These markets are still no where near where they were pre-crisis. Therefore, corporate America needs much higher cash balances to operate.

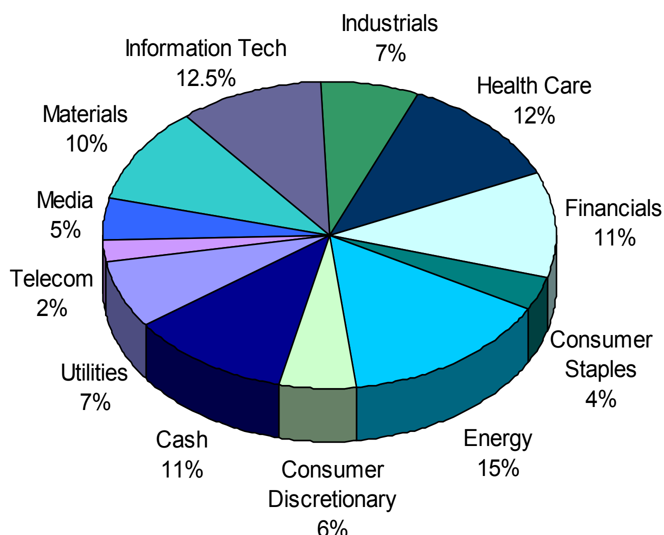
The conditions for this scenario have been developing over time. During the past three decades there was very extensive financial innovation. The degree to which businesses and the entire system came to rely on the liquidity-tools that were developed in this period—both commercial paper and asset backed securitization—was very deep. But with the financial meltdown, both of these tools have become unavailable. To the degree businesses cannot rely on the commercial paper market to fund short term cash needs, they need to hold more cash instead. To the extent they cannot finance their receivables with asset backed securities, they need to turn to other sources of financing. In addition, individuals are also less likely to become comfortable with the amount of leverage they were willing to carry pre-crisis having seen the risks of being over-extended when financing options and credit dried up.

But for a given amount of economic activity, a given amount of liquidity is required. If that liquidity can't be generated through financial products there needs to be more actual dollars available in the system. That is exactly what the Federal Reserve Bank is providing with all its Quantitative Easing. While this increased money supply can be seen as extraordinary relative to historic levels – and while we may have adopted cute new names for it (QE1, QE2 etc) it is simply a large use of classic monetary policy. And it is important and appropriate because the tools to create liquidity that were available before the crisis are simply not options today – and are unlikely to become robust and reliable options any time soon.

The critique of the current expansion is that it has yet to produce several quarters of very strong growth. And that may not occur any time soon. Nevertheless, conditions are in place for continued (albeit bumpy) improvement. Those who try to predict exactly how and when it will happen can easily be whipsawed. We are not following that course. We see very significant opportunities in very stable companies with strong growth prospects that are trading at historically attractive levels. There will be months and quarters where the market performance of these securities will be really robust. And there will be moments where it will be uninspiring. However, three and five years from now I expect to look back and be quite satisfied with the investment exposure we are creating in this period.

Being invested during the early stages of such a long-term advance can create a tremendous impact on portfolio values through the full period. The difference in results between those "sitting in cash on the sidelines waiting for conditions to improve", and those presently generating mid-teen gains, is non-trivial in the near-term. But the impact becomes more amplified as those early gains compound over an extended expansion.

—Charles Lemonides



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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:

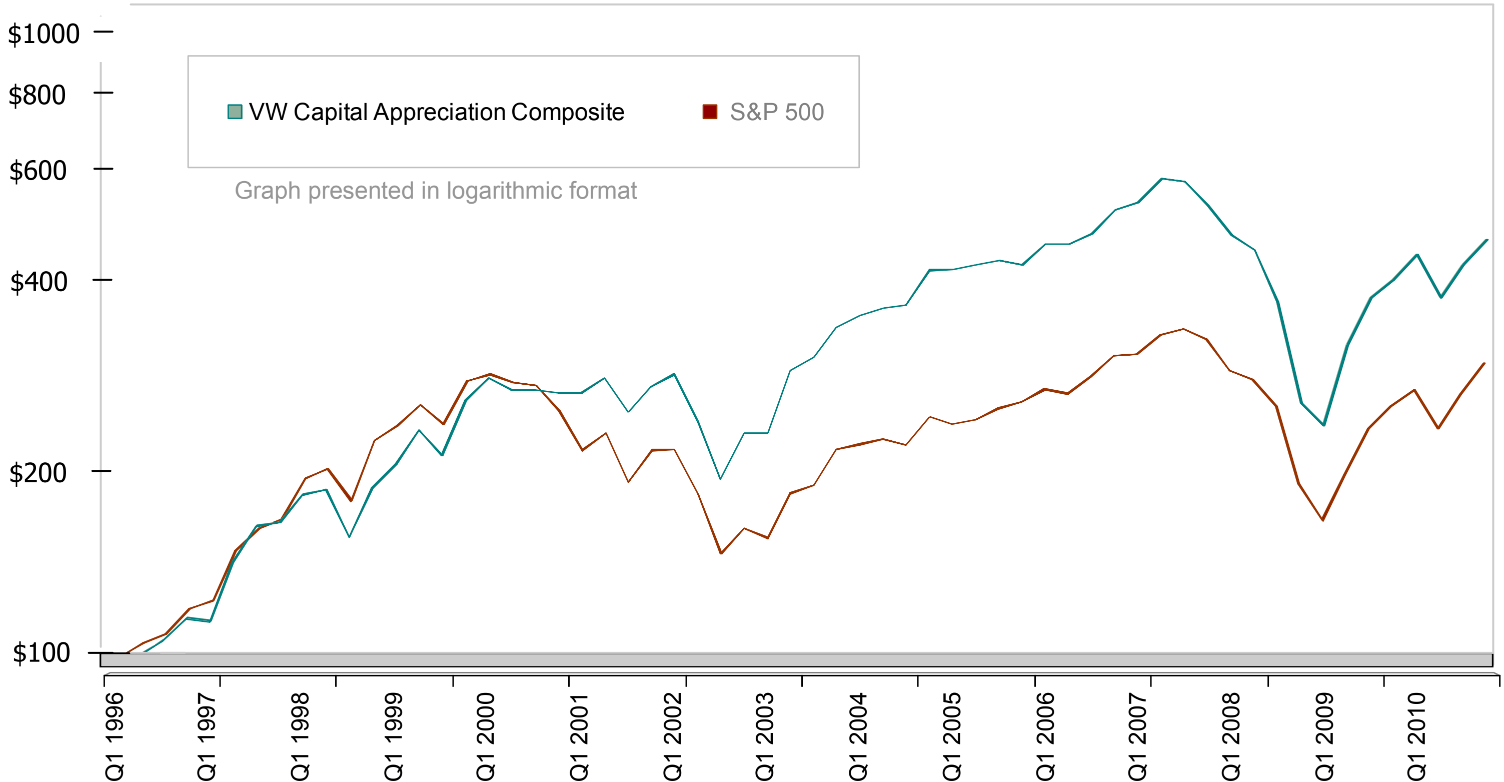
- Individual review of your portfolio requirements
- A separately tailored portfolio created and maintained to your investment objectives and risk tolerance
- Access to the Portfolio Manager on an ongoing basis with timely and responsive communication
- Flexibility to meet your changing tax requirements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

4th Quarter: September 30th, 2010 -- December 31st, 2010

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*
YTD	13.71	12.15	15.04	12.48	10.86	11.30
1 year	13.71	12.15	15.04	12.48	10.86	11.30
5 year	1.64	0.27	2.52	3.62	2.09	4.76
7 year	4.11	2.69	3.78	5.59	4.03	4.71
10 year	5.03	3.58	1.55	6.31	4.67	4.26
LIFE*	9.71	8.04	6.85	10.53	8.74	6.99

* Life is 15.00 years

*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 period under management. Results were generated at other firms prior to 9/30/01. Information on other composites is avail-

As of 12/31/2010 the Capital Appreciation Composite consisted of 221 accounts and $80,796,292 in assets; while the Balanced Composite consisted of 74 accounts and $37,753,606 in assets. Together this represents 98.66% of total accounts and 71.86% of total assets.

Past performance is not a guarantee of future results. This material is approved for client use.

Capital Appreciation

	Total Firm	Composite Assets		Annual Performance Results			
Year End	Assets (in Millions)	USD (in Millions)	Number of Accounts	Composite: Gross	Composite: Net	S&P 500	Composite Dispersion
2010*	165	81	221	13.86%	12.30%	15.04%	8.00%
2009	152	78	241	48.80%	48.80%	28.06%	7.86%
2008	112	58	311	-47.02%	-47.74%	-36.96%	8.58%
2007	295	178	515	1.50%	0.15%	5.49%	5.93%
2006	267	159	411	19.08%	17.44%	15.79%	4.22%
2005	209	119	340	1.81%	0.31%	4.91%	3.73%
2004	165	78	158	20.03%	18.42%	10.88%	4.20%
2003	121	49	93	40.27%	38.25%	28.69%	4.71%
2002	75	33	58	-14.06%	-15.23%	-22.10%	3.53%
2001	85	36	51	2.05%	0.64%	-11.88%	8.31%
2000	80	35	69	2.28%	0.68%	-9.11%	6.64%
1999	81	36	79	32.56%	30.46%	21.04%	15.60%
1998	66	26	78	11.60%	9.68%	28.58%	6.03%
1997	39	9	30	35.65%	32.96%	33.36%	3.84%
1996	26	6	20	19.77%	17.13%	22.96%	4.06%

*Preliminary Indications from Preliminary Data. Compare with Fact Sheet upon its publication later in January 2011

Balanced

	Total Firm	Composite Assets		Annual Performance Results			
Year End	Assets (in Millions)	USD (in Millions)	Number of Accounts	Composite: Gross	Composite: Net	Blended Index	Composite Dispersion
2010	165	38	74	12.47%	10.84%	11.30%	5.15%
2009	152	38	79	45.64	43.53%	16.78%	5.15%
2008	112	33	91	-40.29%	-41.20%	-18.18%	4.82%
2007	295	76	128	4.06%	2.51%	6.45%	3.78%
2006	267	74	113	17.37%	15.61%	9.98%	3.26%
2005	209	65	120	2.29%	0.73%	3.80%	3.29%
2004	165	65	104	19.71%	18.04%	7.70%	4.01%
2003	121	52	84	39.07%	36.86%	16.16%	5.68%
2002	75	33	63	-13.69%	-15.24%	-6.15%	3.52%
2001	85	37	62	4.87%	3.10%	-1.29%	7.36%
2000	80	34	72	6.28%	4.35%	1.02%	5.50%
1999	81	36	73	31.32%	28.89%	9.95%	11.30%
1998	66	37	93	9.13%	7.15%	19.33%	7.63%
1997	39	24	54	34.81%	32.51%	21.18%	4.33%
1996	26	15	29	18.66%	16.54%	12.96%	3.60%

DISCLOSURES

Past performance is not indicative of future results.

Balanced Composite *contains all accounts with a balanced mandate. For comparison purposes the composite is measured against a 50/50 blend of S&P 500 and Merrill Lynch Master Bond Indices. The blended benchmark is calculated on a quarterly basis.*

ValueWorks has prepared and presented this report in compliance with the Global Investment Performance Standards (GIPS®).

ValueWorks is a separate registered investment adviser. Prior to September 30th, 2001, ValueWorks was a subdivision of M&R Capital. The firm maintains a complete list and description of composites, which is available upon request.

Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. Past performance is not indicative of future results.

The U.S. Dollar is the currency used to express performance. Gross returns are shown as supplemental information and are stated gross of all fees and transaction costs; net returns are reduced by all fees and transaction costs incurred. Wrap accounts pay a fee based on a percentage of assets under management. Other than brokerage commissions this fee includes investment management, portfolio monitoring, consulting services, and in some cases, custodial services. Wrap accounts make up 100% of the composite for all periods shown. Wrap fee schedules are provided by independent wrap sponsors and are available upon request from the respective wrap sponsor. The annual composite dispersion presented is an asset-weighted standard deviation calculated for the accounts in the composite the entire year beginning December 31, 2001. From January 1, 1996 to December 31, 2001 dispersion reflected an equal weighted dispersion. Additional information regarding the policies for calculating and reporting returns is available upon request.

The investment fee schedule for the composite is as follows: Low and high rate for wrap sponsors: 1.25% and 2.75%, respectively. Fee schedules from individual wrap sponsors are available upon request. Actual investment advisory fees incurred by clients may vary.

The Balanced Composite was created December 31, 1995. Performance presented prior to October 1, 2001 occurred while the Portfolio Manager was affiliated with two prior firms and he was the only individual responsible for selecting the securities to buy and sell. ValueWorks' is in compliance with the GIPS standards for the period October 1, 2001 through December 31, 2007. In addition, a performance examination was conducted on the Balanced Composite beginning October 1, 2001.