1450 broadway, 42nd fl
new york, ny 10018

phone: 212.819.1818
fax: 212.819.1463

info@valueworksllc.com
www.valueworksllc.com

ValueWorks

quality assets. compelling valuations.

Volume 10,4 **Q4 2012**

Disciplined investors continued to earn healthy returns in 2012. More important, I see the groundwork laid for continued solid returns for the quarters and years ahead.

The Dow advanced by 7.3% for the year, the S&P 500 Total Return added 15.98%, edging the Nasdaq Composite that gained 15.91%. Our Capital Appreciation portfolios were near the middle of the pack and added 12.9% (Gross of fees, see page 4 for additional details). In the quarter our accounts added to their gains, despite an overall market pause. Specifically, the Dow shed -2.5%, the S&P gave back –.38%, and the NASDAQ retreated -3.1%. Over this period our portfolios added 3.87% .

Through 2012 the macro-economic environment continued on a trajectory of measured improvement. Approximately 1.8 million jobs were created, the overall economy grew in the order of 3%, incremental progress was made in addressing Europe's monetary union, and the US took some steps to deal with its fiscal imbalance. Against this backdrop, the market continued to climb its "wall of fear".

My prospective optimism though, is based upon the myriad areas in which we can expect to see further improvement. Washington began to rein-in the massive fiscal stimulus that was helpful in reversing the economic meltdown of 2008-2009 but which is not as clearly appropriate now that the economy has begun to heal. Whatever steps have been taken so far, there is still more to be done. And you can be sure that there will be much hand-wringing in the months ahead as policymakers haggle over the right amount of spending cuts that represent the next step in dealing with this issue.

But it seems highly likely that there will be some progress in removing fiscal stimulus, and that movement in that general direction is a good thing for the economy at this stage of the business cycle. While there will doubtless be market gyrations before it is all over, timing them will prove treacherous, and overall levels should be higher once the issues are settled.

Top 10 holdings*:

1. Nokia Corp 6.625% Due 05-15-39
2. Calpine Corp.
3. American Express Co.
4. Williams Companies
5. Boeing Company
6. Paccar Inc.
7. Pfizer Inc.
8. Xerox Corporation
9. Eli Lilly & Co.
10. Dow Chemical Company

—as of 12/31/12—

*see notes on p4 for additional Information

We have also continued to see improvement in residential real estate. Housing prices have reversed their long decline and have either stabilized or started to move higher, foreclosure rates will likely revert to historic averages within the next year, and new home construction has started to tick higher. But while there is evidence of stabilization, the current state of the housing market is still disastrous by historic measures. The room for improvement is similarly historic. And this improvement should continue to play out over years, not months. There will be meaningful big job creation as the pace of new home construction gets back to a million or a million and a half per year up from the current anemic pace of half a million per year. It will take more than a year to get there, but that represents further extended improvement.

The employment picture is similar. Conditions have improved – and are improving – but there is a long way to go before we reach full employment. The significant amount of slack in the labor force allows for meaningful growth before we bump up against capacity constraints and a consequent uptick in inflation.

Meanwhile, company-by-company, we continue to see excellent opportunities to own solid, market-leading businesses at extraordinary valuations.

Boeing will be churning out increasing numbers of 787's for years to come. Few of us have flown on them yet, but because they are much cheaper to fly, and much more comfortable to fly in, all-composite aircraft will dominate air travel ten years from now. Boeing is the only company building these planes today.

You probably have begun seeing LED light bulbs in the stores over the past twelve months. They are expensive, but the cost of making them continues to come down and they use 1/8 the electricity of conventional bulbs. Cree has been improving them for twelve years, and is making money on them today. They will be ubiquitous within three to five years. If Cree can maintain its edge, the shares should double or triple over that time frame.

By the end of this year, you should be seeing a new generation of TV's with larger size and crisper pictures in the stores. Corning Glass will be making the panels. It will take several years for them to replace current technology, but what seems quite adequate today will seem quite dated by 2016. And Corning shares should advance well before then.

Recent economic uncertainty caused a pause in the pick-up in sales of large class six trucks that Paccar makes. But more goods continue to travel over our roads, and the average age of trucks continues to climb, so the opportunity for Paccar continues to grow.

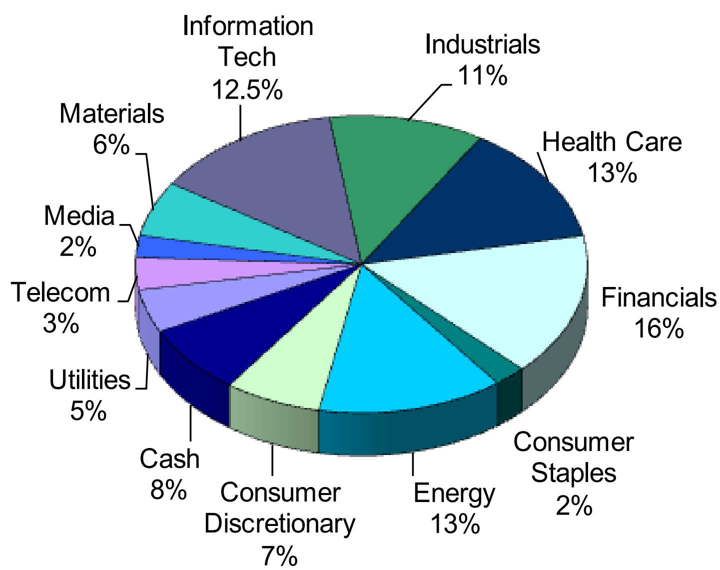
The large pharmaceutical companies saw a wave of patent expirations in the last decade, but they are mostly behind us, and new drugs continue to wind down the pipeline. While both Lilly and Pfizer posted significant gains in 2012, I expect earnings at these companies to be thirty percent higher three years from now, and multiples to be 25% higher, for gains of 50-100% over two to four years.

There has also been a fundamental change in the energy industry sparked by new technology. US oil and gas production is accelerating, and US prices for those commodities are much lower than in Europe or Asia. That should prove to be a boon for Williams, Chesapeake, Calpine and Dow Chemical.

It has consistently been my contention that monetary policy works. The Fed has been pumping out liquidity to counter the financial meltdown, and it has been working – but there is still a long way to go. The markets have yet to exceed their highs of 2000. I expect them to get through those levels in 2013, and for those levels to eventually provide a floor for further advances. And you can be assured there is a veritable army of investors waiting on the sidelines for today's problems to be solved before they are willing to put money to work. Each year that goes by may make them feel more comfortable, but the trade-off will be a higher and higher entry point.

— Charles Lemonides, CFA

Sector Diversification--
Capital Appreciation Composite



Contact:

ValueWorks LLC
1450 Broadway, 42nd floor
New York, NY 10018

email:
info@valueworksllc.com

Call us:

212 819 1818 (NY)
212 819 1463 (Fax)
866 567 4523 (Toll Free)

Visit us on the web:
www.valueworksllc.com

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:

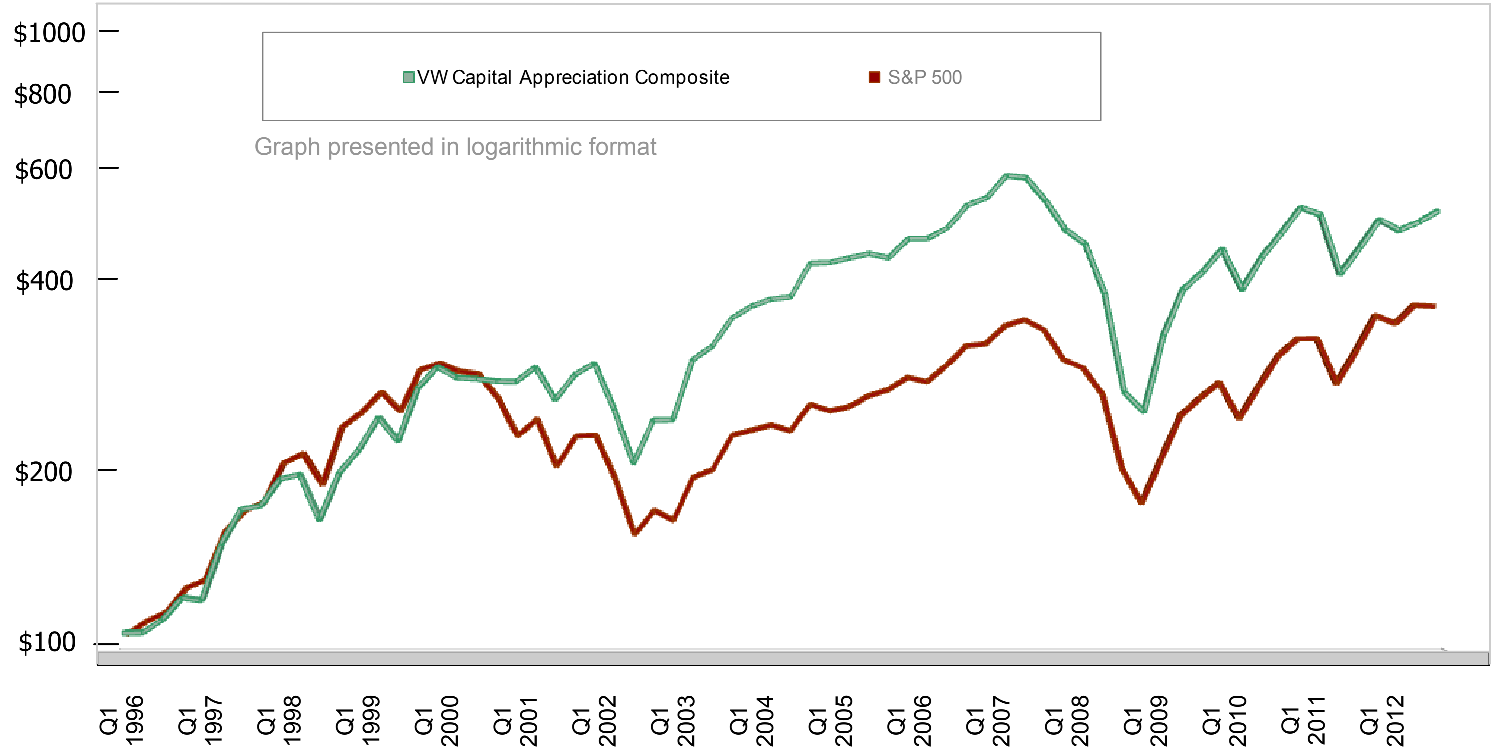
- Individual review of your portfolio requirements
- A separately tailored portfolio created and maintained to your investment objectives and risk tolerance
- Access to the Portfolio Manager on an ongoing basis with timely and responsive communication
- Flexibility to meet your changing tax requirements 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, 2012 -- December 31st, 2012

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*
2012 Q4	3.87	3.53	-0.38	3.76	3.39	-0.07
1 year	12.92	11.49	15.98	12.28	10.70	10.46
5 year	-0.67	-1.97	1.59	1.13	-0.32	4.60
10 year	7.20	5.75	7.07	8.20	6.61	6.65
LIFE*	9.00	7.37	6.99	9.74	7.99	7.08

* Life is 17.00 years (inception, 1/1/1996)

*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 12/31/2012 the Capital Appreciation Composite consisted of 150 accounts and $70,149,865 in assets; while the Balanced Composite consisted of 65 accounts and $34,784,461 in assets. Together this represents 98.17% of total accounts and 62.70% of total assets.

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

PROCESS:

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	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
2012	167	70	150	12.92%	11.49%	15.98%	1.84%
2011	160	75	193	-4.58%	-5.80%	1.85%	1.64%
2010	165	81	221	13.71%	12.15%	15.04%	5.25%
2009	152	78	241	48.83%	46.92%	26.48%	7.86%
2008	112	58	311	-46.97%	-47.68%	-36.96%	8.58%
2007	295	178	515	1.50%	0.14%	5.49%	5.93%
2006	267	159	411	19.08%	17.44%	15.79%	7.25%
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	40.31%	38.29%	28.69%	4.71%
2002	75	33	58	-13.97%	-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%

DISCLOSURES

Past performance is not indicative of future results.

Capital Appreciation Composite *contains all accounts with a Capital Appreciation mandate. For comparison purposes the composite is measured against the S&P 500 Index.*

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 management fee schedule 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 Capital Appreciation 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 Capital Appreciation Composite beginning October 1, 2001.

For more information about ValueWorks Capital Appreciation Composite and our other composites please visit valueworksllc.com or call 212.819.1818
This material is approved for client use.