ValueWorks
quality assets. compelling valuations.

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The market continued to climb a steep wall of fear in the third quarter. The Dow tempered the pace with a 2.1% gain in the quarter and 17.6% gain for the three quarters. The S&P 500 did a bit better with returns of 5.2% for the quarter and 19.7% for the year-to-date, and the Nasdaq led the advance with 11.2% for the quarter and 26% for the year. As you can see from the tables on page 4, we continued to do quite well even relative to these very strong advances. This quarter our Capital Appreciation composite added 7.19% for a 31.6% gain YTD (gross of fees).

Five years after the financial panic, there still remains very significant unused capacity in the economy. Such excess capacity creates the potential for above average economic growth over a multi-year period. And because it will likely take more than a year or two for the economy's present challenges to be resolved, we expect the period of improvement to be similarly extended. The take-away for me is that five years from now, when we look back at this moment in time, we will be looking back at an economy poised for an extended period of above average growth and market levels that proved to be a floor, not a ceiling.

Among investor "fears" is the very fact of the market's advance. Equity indexes have broadly recovered to their old highs, yet economic conditions remain quite challenged.

Top 10 holdings*:

1. Boeing Company
2. American Express Co.
3. Xerox Corporation
4. Nokia Corp. 6.625% Due 05-15-39
5. Cliffs Natural Resources Inc.
6. Calpine Corp.
7. Paccar Inc.
8. Williams Partners
9. Pfizer Inc.
10. 3M Company

—as of 09/30/13—

*see notes on p4 for additional Information

But this bearish view dismisses the reality that the US economy (and even more so the global economy) is much larger than it was at either of the previous market peaks. Nominal GDP peaked at $14.7 trillion rate in 2008 compared to the current rate of $16.7 trillion. That compares to $9.9 trillion at the market peak of 1999/2000. Ultimately the value of companies is related to the amount of profits they can generate, and that in turn is related to their size, which – in total – is related to the size of the economy they operate in. So while the index number might be the same (i.e. the S&P 100 index was 750 in 2000, and in 2008, and is now 750), its "price" relative to the economy is actually much lower.

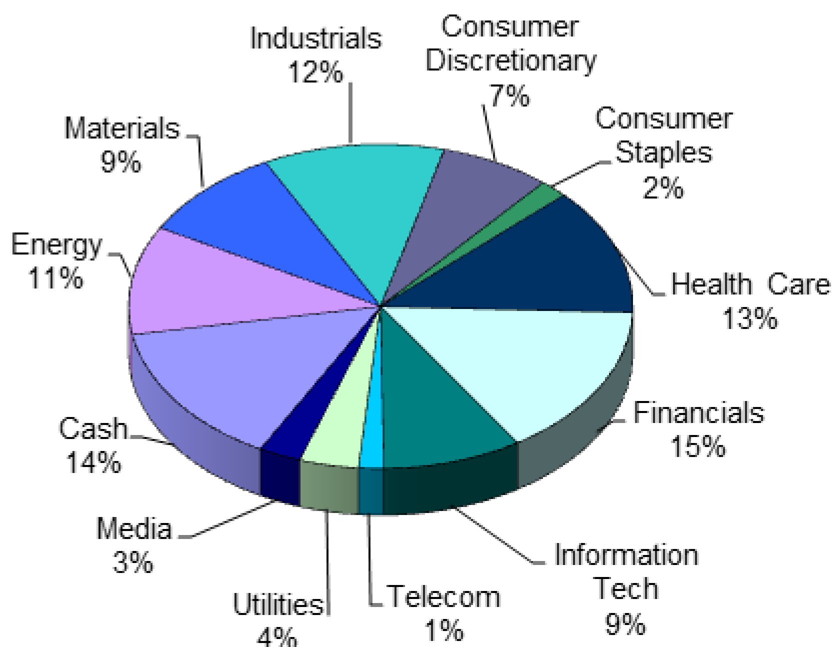
Such a "big-picture" macro-interpretation is consistent with what I see on a micro, company-by-company basis. While equity valuations on individual companies are not as compressed as they were during the worst of the sell-off (I don't expect to see that sort of "opportunity" again in my career), they are, in my judgment, much lower than they were at earlier market peaks. While we were able to find some issues that we considered attractively priced at those peaks there is a much wider range of well valued issues today – and many fewer over-extended issues.

To put this in perspective, in 1999 Eli Lilly traded at $80 per share and 40 times earnings. Today it trades at $51 per share and 12 times earnings. Cisco traded at $70 per share and 100 times earnings; today it trades at $23 per share and 14 times earnings. I may not be in the majority, but I expect each of these companies to have better earnings growth in the next ten years then they actually had in the last ten. And the multiples are orders of magnitude lower than they were. I see the same sort of pricing discrepancies in a very wide range of companies, from Legg Mason, to Dow Chemical, to Chesapeake Energy to Williams Pipelines and Cliffs Natural Resources.

That is not to say that I expect all smooth sailing from here. I don't. There will be storms and squalls and downside surprises that seemingly come out of the blue. But there will also be periods of upside expansion that will be equally unpredictable. And if corporate assets earn positive returns over time, the mistake is not in being invested into a sell-off – time fixes that problem; the risk is not being invested during an advance. If equities earn positive returns, markets will always bounce back up from lows – they will not always bounce back down from highs.

As always, we will continue to manage the portfolio to be able to react to either. Through the rapid advance of the past 12 months names in our portfolio have hit our estimation of fairly priced more quickly than we have replaced them. Cash balances are modestly higher than our historic average as a result. As the pace of the advance inevitably moderates, I expect us to add some good complements to our existing holdings.

— Charles Lemonides, CFA



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