VALUEWORKS
QUALITY ASSETS COMPELLING VALUATIONS

VOLUME 13,2 SECOND QUARTER 2015

Markets continued to churn sideways through the last quarter. The S&P 500 eroded -.23%, the Dow -.88%, while the Nasdaq eked out 1.75% and the Russell 2000 Value index gave back -1.94%. A quick glance at the performance tables on p.4 will show that the performance of our portfolios was as thoroughly uninspiring.

Underneath this "top-line" stasis there have been a series of major rotations setting equities up for a fundamentally different dynamic. It is more than simply a "pause that refreshes." Rather, the turmoil below the surface has been quite meaningful. I would characterize the past eighteen months as embodying a series of rolling bear markets. To me it is reminiscent of the rotations that intermittently occurred during the period from the early 1980s through 1989, and from 1992 or so to 1999.

One driver of this rotation represents a reaction to continued economic growth. The US added over 600,000 jobs in the last quarter, consistent with 3% GDP growth. Confidence that the prolonged period of ultra-low interest rates is nearing an end sent the Utilities indices down roughly 10% for the year, fairly evenly split between the first two quarters. The Dow Jones REIT index shed roughly 14% from its high in late January to June 30th. Income oriented energy pipeline investments declined similarly.

Sectoral support was driven by biotech and healthcare shares for another quarter. We were well served by our holdings in Gilead, Ely Lilly, Boston Scientific and Pfizer, while activist investors triggered big gains in Allergan. Similarly, the gains in other areas of the market were more driven by buyout and restructuring prospects at specific companies. This is often the signal of an important positive development as market leadership, driven by improved business fundamentals, shifts from an overextended group to a fresh sector.

Among the diverse holdings currently in the portfolios are many that could provide leadership for the next leg of a market advance. Both LiveNation and The NY Times benefit from improved consumer spending and a digital interaction with their customers, each leads its industry and both trade at fair valuations. Bombardier, a maker of trains and planes, and Paccar, a builder of large trucks, represent a very different business dynamic, but could easily be the type of investment that provides the next leg of market leadership. Similarly,

## TOP 10 HOLDINGS

1. Boeing Company
2. Eli Lilly & Co.
3. American Express Co.
4. Gilead Sciences Inc.
5. Xerox Corporation
6. Dow Chemical Company
7. Boston Scientific Company
8. Pacaar Inc.
9. Pfizer Inc.
10. Calpine Corp.

—As of 6/30/15—

*see notes on pg 4 for additional details

American Express and Legg Mason are financial companies trading at fair prices but are further than their peers from the regulatory crosshairs. That sector has consolidated for quite some time, and is looking at very solid prospects. Should “old-tech” catch investors’ attention, we can expect to get a solid advance from Cisco, Hewlett Packard and Xerox. We have also put several names in the portfolio that should provide a nice lift as their industries stabilize, but whose sectors are more likely several years away from providing long term leadership. Once the commodity and energy sectors stabilize, names like StarBulk, National Oilwell, and Cliffs Natural Resources could each climb by +25% in a handful of months given how massively compressed their valuations are – even if it then takes several more years for them to generate 100-200% ad-

vances from today's levels.

Surely over the past several weeks and months investors and the media have been more concerned with what is happening in Europe – and whether Greeks vote yes or no – than on where leadership for the next stock market advance is coming from. That is understandable given the compelling nature of those developments. There is a powerful human dimension, a complicated theoretical economic dimension, and a potentially historic political dimension – as well as prosaic investment risks and opportunities. Being a firm believer in the efficacy of counter-cyclical fiscal and monetary policy, I have never bought on to austerity as a cure for economic contraction. I railed against those policies as they were foisted on South American economies in pre-9/11 2001, and in the European Union in 2010, and I see them as counter-productive in Greece today.

*"The investment decisions we are implementing through this transitional period are designed to be the right choices for the next one to three years."*

Given that the Greek government has been running a primary fiscal account surplus (even with an economy that is severely depressed), and given that the economic amount of debt outstanding (versus the face amount), is not particularly high versus current GDP, and given that the challenge is not to find new sources of financing, but rather extend the financing that has already been put in place, there is plenty of room to put a more accommodative program in place. For example, the IMF extended tens of billions of Euro in credit as the crisis unfolded. A modest amount (under $2 billion) was due over the past month. However the IMF has been operating with the expectation that it would put off the maturity of that debt – they are not arguing that it is healthy for Greece to drain those resources from the economy today and repay that debt, and they are not arguing that they are generally unwilling or unable to roll that debt forward. On the contrary, they are saying that is what they think should be done.

However, because the Greek government is generally opposed to the austerity program (in part under the theory that fiscal contraction – higher taxes and lower spending – will serve to further contract the economy, and in part on the premise that a $700 per month pension plan is as much a contractual and principled obligation as is debt to creditor) the IMF, in opposition to their own stated inclination, is demanding repayment now. The IMF and the Greek government are creating a liquidity issue now because they cannot come together to create the right policy going forward.

Ultimately there are two schools of thought on the issue, and it is not clear which will prevail in the days and months ahead. Remember, in late summer 2008 there were those who believed the right course was to keep conditions tight to punish "moral hazard." I doubt that there is the same level of risk here, but it seems clear that some decisions can lead to further contraction; the near-term outcome for Greece and the EU will hinge on the decisions that have not yet been made. Longer-term though, the situation will resolve itself. And if there is further contraction, there will be some benefits to be reaped. The Greek political system has probably had as good a refreshing as any, with a very sclerotic system very much shaken up, and the fittest of economic actors will be the ones that reinvigorate growth.

For us, the investment decisions we are implementing through this transitional period are designed to be the right choices for the next one to three years (acknowledging that they have not been the best performing over the past twelve months) under a wide range of potential outcomes. After all, our strategy has always been to position for solid performance in many different environments rather than an all-or-nothing approach of gunning for the best results in one particular environment.

-Charles Lemonides, CFA

## 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.

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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.

## 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.

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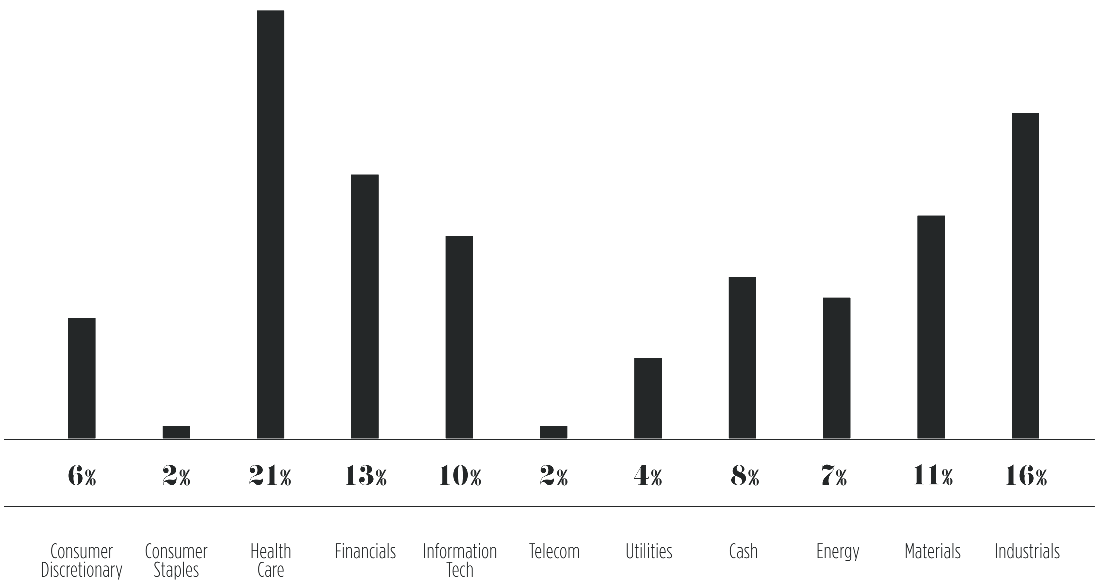
### *Objective*

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.

## SECTOR DIVERSIFICATION

### CAPITAL APPRECIATION COMPOSITE




## 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.

## OUR PORTFOLIO STRUCTURE

We believe risk can be better contained through educated security selection than through over-diversification. 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.

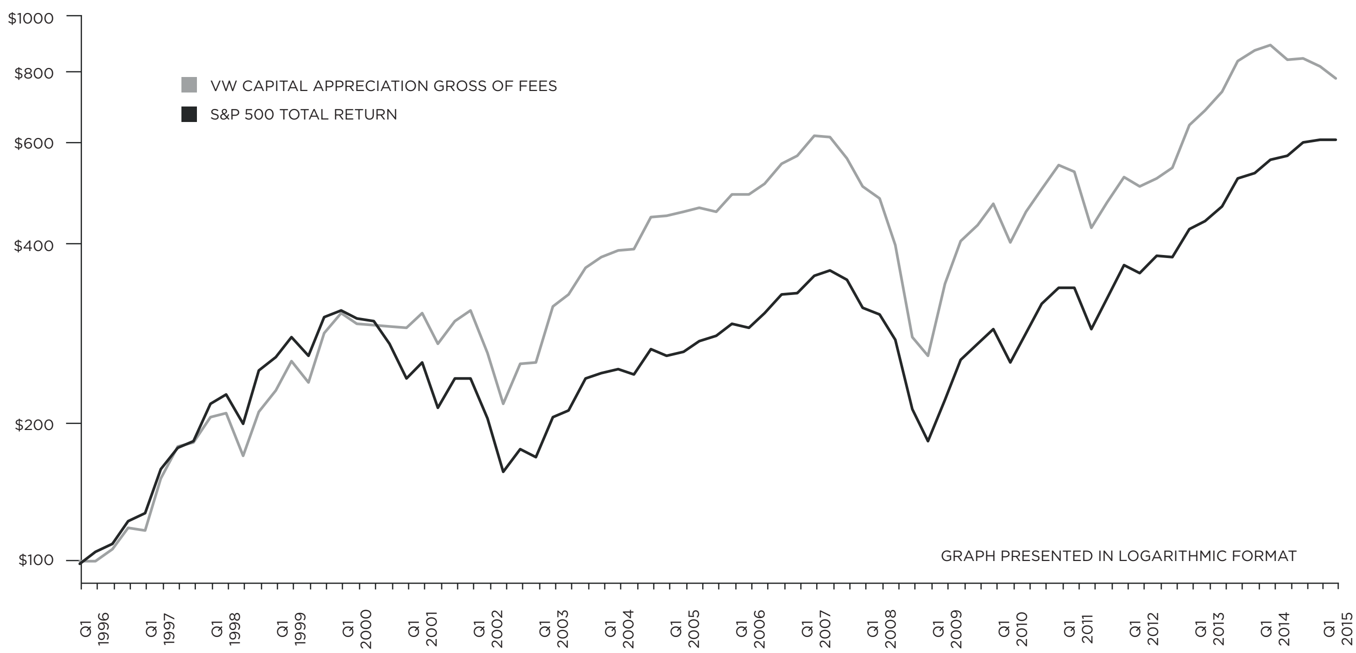
Because our decisions are based on research and sound fundamentals we view depressed price action on our securities as buying opportunities rather than sell signals.

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.

# VALUEWORKS

## PERFORMANCE REVIEW

**SECOND QUARTER** MARCH 31, 2015 - JUNE 30, 2015




## TRAILING PERFORMANCE DATA

### VALUEWORKS' CAPITAL APPRECIATION COMPOSITE

| | GROSS OF FEES | NET OF FEES | S&P 500 TR |
|---|---|---|---|
| **2015 Q2** | -3.77 | -4.06 | 0.28 |
| **1 year** | -10.91 | -12.02 | 7.43 |
| **3 years** | 13.94 | 12.53 | 17.31 |
| **5 years** | 12.51 | 11.09 | 17.28 |
| **10 years** | 4.95 | 3.58 | 7.86 |
| **Life*** | 9.63 | 8.02 | 8.38 |

*Life is 19.50 years (inception 1/1/1996)

### VALUEWORKS' BALANCED COMPOSITE

| | GROSS OF FEES | NET OF FEES | BLENDED INDEX* |
|---|---|---|---|
| **2015 Q2** | -4.49 | -4.84 | -0.76 |
| **1 year** | -8.74 | -10.07 | 4.67 |
| **3 years** | 13.22 | 11.64 | 9.12 |
| **5 years** | 11.69 | 10.14 | 10.31 |
| **10 years** | 5.89 | 4.37 | 6.53 |
| **Life*** | 10.19 | 8.45 | 7.36 |

*The "Blended Index" is a calculation comprised of 50% S&P 500 and 50% Merrill Lynch Domestic Master Bond Index.

**PAST PERFORMANCE MAY NOT BE INDICATIVE OF FUTURE RESULTS.**

This Newsletter is intended to be presented with the Capital Appreciation Fact Sheet which contains additional disclosure information.

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 available on request. Investments in this strategy may lose value.
**This material is approved for client use.**

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