

# ValueWorks:

Redefining wealth management through critical thinking and independent research

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VOLUME 2, 4

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## A Robust discipline . . .

We are now up 49.82% for Capital Appreciation accounts and 44.07% for balanced accounts over the past year. Over the life of our composites (since 1996), we have earned 179% and 183% cumulative returns respectively.\* By way of contrast, the S&P advanced 24.38% over the past year and 78% since the beginning of 1996.

This recent cycle has provided us with the opportunity to earn very healthy (and uncommon) returns. I believe this is due to staying true to our clear-cut investment discipline through tremendous volatility. That is what is reflected in the portfolio results above. We have kept our focus on putting money to work in quality assets at compelling prices. Market volatility has neither distracted nor paralyzed us, but has given us an opportunity to exit fully priced issues and to put money to work in better priced claims.

And while I have on a quarterly basis offered my piece of market commentary, we have never been swayed from the basic work of investing—using independent judgment to appraise and value assets and the price paid to control them.

This is at the core of our deep and robust value discipline; it is not a formulaic approach based on specific metrics like low P/E ratios or high ROE figures. Consequently, we have been able to move between different areas of opportunity often weighting very different aspects of the portfolios at different times. Recently, we have upgraded the quality and upside potential of our holdings focusing our attention on more brand name opportunities than are usually available. Our portfolios are now flush with securities that are both very attractively priced and of higher quality, in my opinion, than has generally been true over the nearly eight year life of our composites. As a value investor who focuses on out of favor companies, I consider it as “blue chip” a portfolio as we have ever owned.

### ValueWorks' Top 10 holdings\*:

1. **Calpine Cap Tr III pfd**
2. **Sony Corp. ADR**
3. **Conexant Systems**  
**4% bonds due '07**
4. **Freddie Mac**
5. **Pfizer Inc.**
6. **Cablevision 11.75% pfd**
7. **Apple Computer**
8. **Baxter International**
9. **Rowan Companies**
10. **Chesapeake Energy**

—as of 9/30/03—

\*see notes on p4 for additional information

Our core holdings now include Pfizer, Disney, Freddie Mac, Baxter Int'l, Apple Computer, General Motors, Williams Companies, Sprint and Sony. Clearly these are all now somewhat out-of-favor, but they were all one-time (and I believe at least some will prove future) investment icons. Despite the recognizability of the names, these securities together represent diversity across sectors and complement the rest of our portfolio (fig 1, page 2).

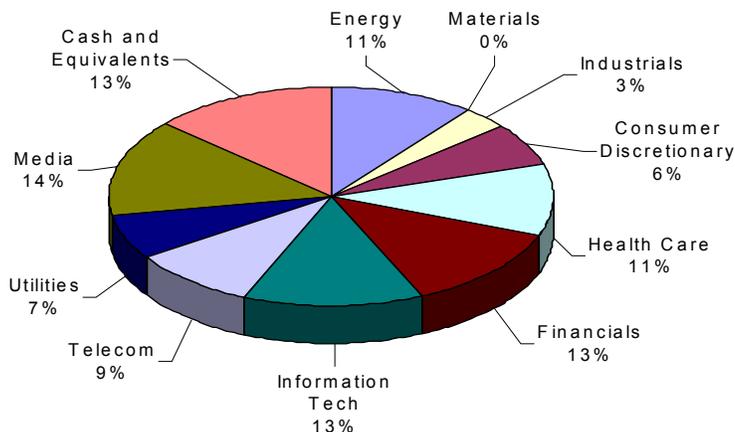
Diversification for us extends to finding the best claim on a company's assets anywhere on the capital structure. That can mean looking at bonds or preferred instruments in addition to common shares. We are consequently diversified across asset classes as well as sectors (fig 2 a & b, page 2). This high level of diversification is achievable because of the robustness of our discipline, and has been key to our participating in up markets and being more stable in down markets.

These are the dividends earned from first applying then sticking to our discipline through market tumult. We have used market volatility and emotionalism not only to earn returns, but also to upgrade the quality of our portfolios, and position us even better for the next leg of this market cycle.

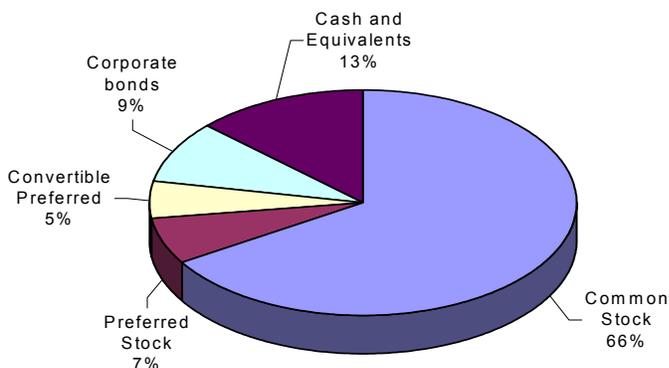
-Charles Lemonides CFA

Our discipline enables broad diversification across sectors. Fig. 1 shows the very even distribution to almost all of the S&P's designated sectors in the current makeup of our Capital Appreciation Composite (right).

**Fig 1. Diversification Across Sectors**



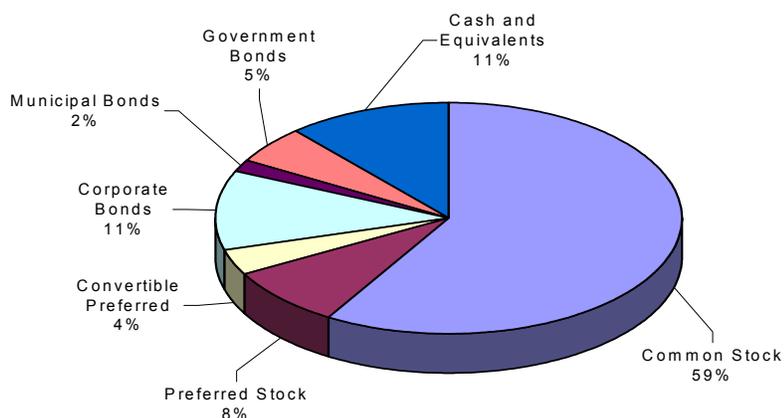
**Fig 2a. Asset Class Diversification-- Capital Appreciation**



To us, owning quality assets at compelling prices is a great start, but it is important to use all the corporate ownership options available to find the claim on assets with the most attractive price. As a result we own securities that cover the full expanse of the capital structure—which is also an additional diversification tool (fig 2a & b).

Our Capital Appreciation portfolios are constructed with an equity foundation (above) and blend in other instruments where their prices, and the assets they allow us to control, are particularly compelling. The Balanced composite uses the same framework, but introduces an income/stability component by including more corporates as well as some Government and Municipal bonds for the more income oriented or conservative investor (right).

**Fig 2b. Asset Class Diversification-- Balanced**



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### **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 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.

### **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:

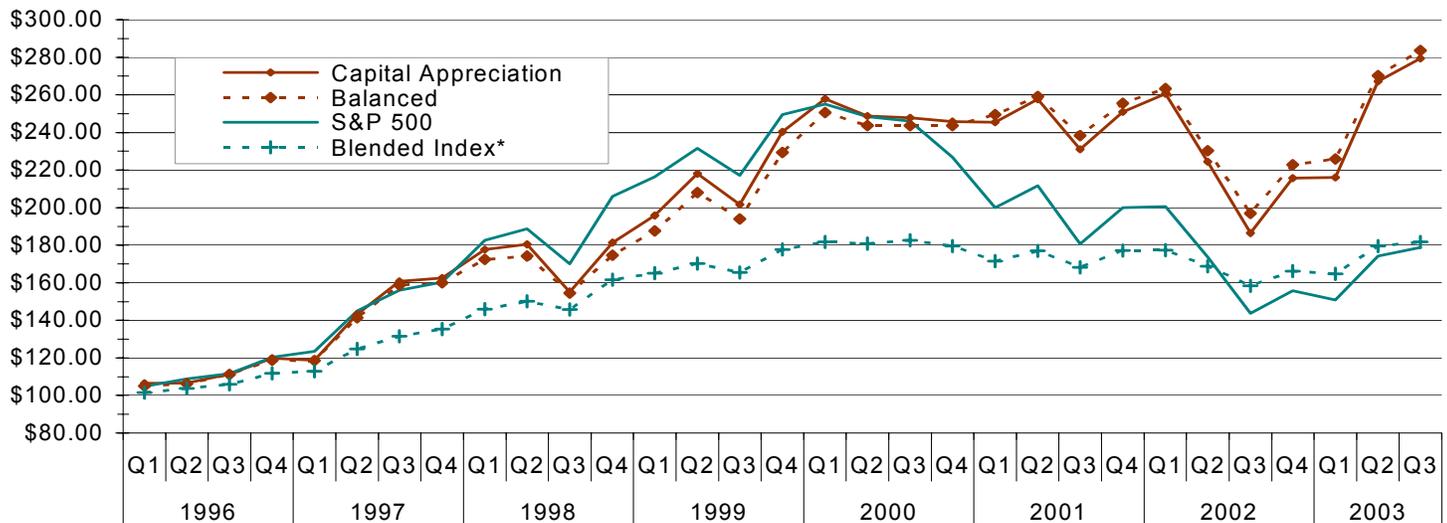
- Individual review of your portfolio requirements
- A separately tailored portfolio created and maintained to your investment objectives and risk tolerance
- Access to the Portfolio Manager on an ongoing basis with timely and responsive communication
- Flexibility to meet your changing tax requirements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

Working within the framework of our value investment discipline, we build portfolio's that cover a wide spectrum of risk-tolerance, from aggressive to much more conservative and income oriented.

# ValueWorks: Performance Review

3<sup>rd</sup> Quarter—September 30, 2003

## Historical Growth of \$100 (gross of fees)



## 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* |
| <b>Rolling 7 Year Return</b> | <b>14.04</b>                               | <b>12.20</b> | <b>6.96</b> | <b>14.32</b>                   | <b>12.30</b> | 8.01           |
| Rolling 5 Year Return        | 12.51                                      | 10.83        | 1.02        | 12.90                          | 10.91        | 4.52           |
| Rolling 3 Year Return        | 4.08                                       | 2.59         | -10.09      | 5.18                           | 3.38         | -0.15          |
| Rolling 1 Year Return        | 49.82                                      | 47.71        | 24.38       | 44.07                          | 41.74        | 14.85          |
| YTD Return                   | 29.55                                      | 28.17        | 14.70       | 27.23                          | 25.70        | 9.37           |
| <b>Q3 Return</b>             | <b>4.59</b>                                | <b>4.21</b>  | <b>2.65</b> | <b>4.89</b>                    | <b>4.47</b>  | <b>1.27</b>    |

\*The 'blended index' is 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 month under management. Exiting accounts are included through the last full month under management.

"Top 10 Holdings" are compiled from the aggregate holdings of the ValueWorks' Capital Appreciation Composite. Neither this nor any other reference to specific securities in this publication is intended to be a recommendation to purchase or sell these or any other securities.

The Capital Appreciation Composite consisted of 74 accounts and \$42,700,230 in assets as of 9/30/03; the Balanced Composite consisted of 74 accounts and \$42,499,999 in assets as of 9/30/03. Combined, these represent over 99% of the accounts, and approximately 85% of the assets managed by ValueWorks LLC. These results were generated at other firms prior to the fourth quarter of 2001. Results for other composites are available upon request.

**Past performance is not a guarantee of future results.**