VALUEWORKS
QUALITY ASSETS COMPELLING VALUATIONS

VOLUME 15,4 FOURTH QUARTER 2017

Healthy and Happy New Year! The year that just ended was another productive one for our portfolios. The year that just ended was another productive one for our portfolios; over the full period our Capital Appreciation group of accounts added 24.7% (gross – see details on page 6). While it is quite reasonable to expect a correction (or at least a significant pause) after the type of advance we have seen over the past two years, it is also true that the conditions are in place for this expansion to accelerate into a speculative boom over an extended number of years.

This advance has been, and could remain, quite selective; a rising tide did not lift all boats. The delta between stronger and weaker performing securities and between winning and losing sectors has been substantial. The tip of this is visible in the major indexes. Value indices of smaller- and larger-capitalization companies (represented by the Russell 2000 value and Russell 1000 value respectively) dragged down average investor returns for the year with gains of 5.35% and 10.66%. The tech-heavy Nasdaq 100, which is now dominated by a handful of very fully priced names, led the advance with a 30.05% gain for the year. The S&P 500 was in the middle with an 18.87% return.

The drivers of the Nasdaq outperformance were names like Amazon, Nvidia and Netflix: companies with extraordinary growth potential but whose prices were extremely high to start the period and are simply more elevated now. Our strong performance is not explained by a natural exposure to those types of securities. Rather our results were made possible by specific security selection. For example, while the Russell 2000 value index performed poorly, several of the larger contributors to our solid results were squarely in that index.

When, as in the past year, there is a large and growing gap in share price performance of companies perceived as economic winners versus economic losers, value stocks as a group underperform. On the other hand, in a portfolio positioned to have exposure to companies that get reassessed from losers to winners (buying issues viewed as value stocks and selling the same issues when they are considered growth stocks), the valuation change is in multiples rather than percentages. I attribute much of our performance in 2017 to that type of reappraisal in several of our holdings. Our portfolio remains stocked with names that I consider poised for this kind of reassessment.

The conditions exist for this type of economic and market activity to continue and, over the course of several years, could transition to an overheated, speculative, boom-type environment. This can represent both risks and opportunities for our investment style.

While policy makers – specifically the Federal Reserve – may adequately drain excess liquidity before it trips into "irrational exuberance," they also may not. It seems more likely that: fiscal policy embodied in the recent tax overhaul will stoke economic growth; current fundamental economic improvement will continue; and speculative excess will feed on itself.

Fiscal stimulus in the tax plan will encourage economic growth. It may come at a price in terms of long term deficits and less room should accommodation be needed later, but for 2018 and 2019, it should provide an economic bump. This is especially true because the stimulus may turn out to be larger than estimated as business owners look for ways to convert regular income taxed at nearly 40% into corporate income taxed at 20%.

Also, even without a tax cut boost, the economy is fundamentally expanding and has plenty of room to go. The classically cyclical parts of the economy are not at peak levels and can provide ample demand from here. While real estate investment has improved, housing starts remain at under long-term replacement levels. Before we reach a peak, we will be building at higher than replacement levels. Capital spending levels in the commodity space were cut to the bone at the trough of the downturn two years ago; they will be much higher before we reach a peak. Plenty of other smaller but still important economic sectors – from aircraft to shipping – are similarly positioned.

Lastly, investor psychology and risk appetite are both shifting. Ten years after an economic crash, memories are just beginning to fade. This evidences itself in numerous ways. Market leadership is in very highly valued growth names

TOP 10 HOLDINGS

1. Qualcomm Inc.
2. Maui Land & Pineapple Co.
3. American Express Co.
4. Corning Inc.
5. Comcast cl A
6. Cliffs Natural Res 6.25% Due 10-01-40
7. Live Nation Entertainment
8. Brunswick Corporation
9. Eli Lilly & Co
10. Amgen Inc.

—As of 12/31/17—

*see notes on pg 4 for additional details

We will stay disciplined through whatever comes. We will continue to look for investments that are compellingly priced now, but may get reassessed as having explosive growth opportunities.

rather than the income oriented (think MLP's) and super stable consumer product names of two plus years ago. More and more, investors are willing to entertain exciting, transformative ideas as they put money to work. Driverless cars are talked about as impacting economic growth.

At the leading edge of this trend is investor appetite for "digital currency" and the changing notion of what is accepted as money. Given that investors are now holding something like $500 billion in market value of "crypto currencies," this phenomenon cannot be ignored as a fringe, inconsequential idea. True believers in these currencies and the blockchain technology that underlies them are sure that the global payments system will be remade over the next decade or so based upon these technologies.

I don't know. But I do know that investor reaction to them today is very consistent with the early stages of a bubble. Bubbles do have an underlying logic and end up sucking in capital. Many change the world. Before they fully run their course, valuations go to startling levels; those not invested in them watch those they dismissed as irresponsible speculators amass shocking wealth. When the momentum reverses the downside is a most painful hangover, but the upside along the way is stunning.

There are plenty of ways the transition to the speculative bubble stage of the economic cycle may be put further off. But economic cycles have not been repealed, and the pattern will be repeated. I have often said that the second half of a market up-cycle is the harder part to navigate. The most dynamic parts of the market, areas that generate huge wealth and excitement, end up as a game of Russian roulette; those who stay too long, well, you know. Those not willing to invest early are taunted at each leg higher as they watch those around them book incredible paper gains year after year. The market top will be recognizable once those taking absurd risks are counted sage, and the hordes of skeptics convert, parting with their capital at hard to fathom levels.

We will stay disciplined through whatever comes. We will continue to look for investments that are compellingly priced now but may get reassessed as having explosive growth opportunities. It is a harder strategy to execute than simply buying in sectors that are cheap and likely to stay cheap. And it is harder than going right up the middle and buying companies with great trailing performance and really extended share prices. That strategy will be easy, and really fun on the way up, and seem quite wise, but will end badly.

We have seen this before. No doubt there will be periods when our performance will not be the most exciting. But if we stick to our discipline and execute it well, we should earn solid returns on the way up and protect reasonably once the initial top is behind us. And if a bubble does not develop at this point we will have appropriately invested portfolios that are designed to perform in whatever conditions do come our way.

-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.

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*

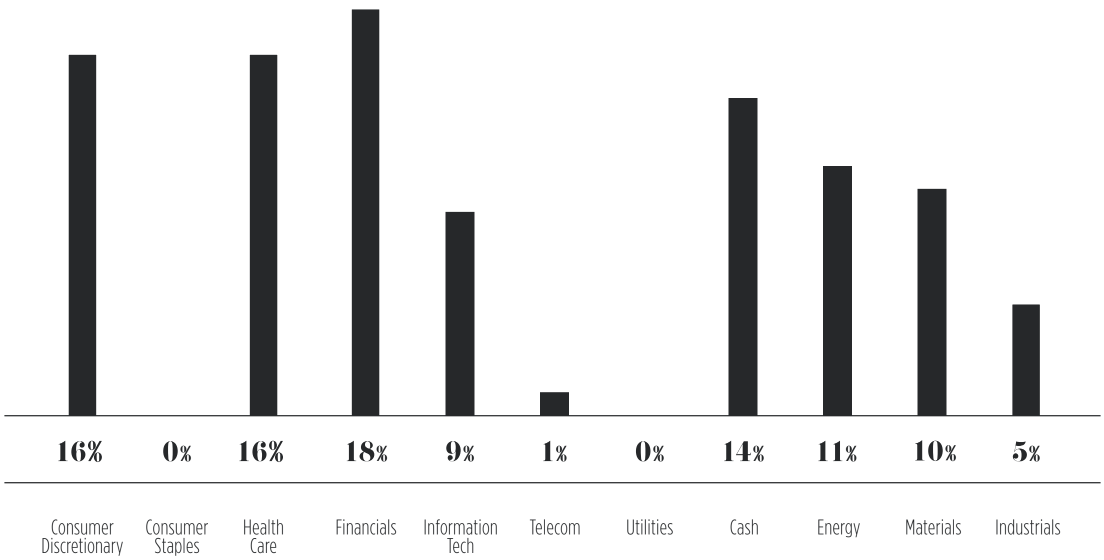
We exit a position when a security either reaches full valuation or changes in its outlook invalidate part of our original thesis.

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.

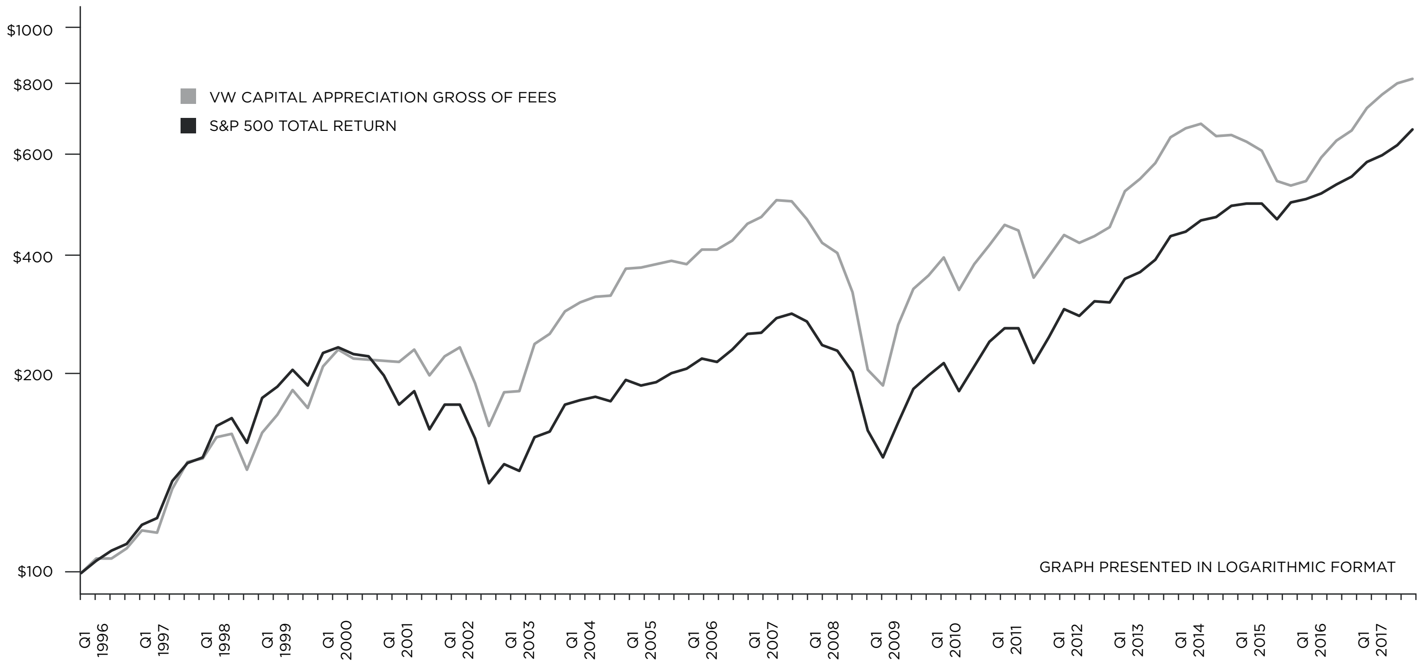
Because our decisions are based on research and sound fundamentals we view depressed price action on our securities as buying opportunities rather than sell signals.

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

FOURTH QUARTER 2017 October 31, 2017—December 31, 2017



TRAILING PERFORMANCE DATA

VALUEWORKS' CAPITAL APPRECIATION COMPOSITE

	GROSS OF FEES	NET OF FEES	S&P 500 TR
2017 Q4	2.35	2.05	6.64
2017 YTD	24.69	23.27	21.84
1 year	24.69	23.27	21.84
3 years	8.27	6.98	11.43
5 years	13.49	12.12	15.80
10 years	6.17	4.84	8.46
Life*	10.01	8.43	8.93

*Life is 22 years (inception 1/1/1996)

VALUEWORKS' BALANCED COMPOSITE

	GROSS OF FEES	NET OF FEES	BLENDED INDEX*
2017 Q4	2.09	1.75	3.52
2017 YTD	20.15	18.59	12.48
1 year	20.15	18.59	12.48
3 years	6.95	5.50	6.85
5 years	12.22	10.69	8.66
10 years	6.53	5.04	6.61
Life*	10.30	8.60	7.44

*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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