VALUEWORKS
QUALITY ASSETS COMPELLING VALUATIONS

VOLUME 14,4 FOURTH QUARTER 2016

2016 proved to be very productive for our portfolios. The broad market measures performed well; the Dow Jones gained 13.4%, the S&P 500 just under 12%, the Nasdaq trailed with a 7.5% advance and the Russell 1000 Value led with a 17% gain. Our portfolios performed quite well, even when compared to those fairly robust returns; the Capital Appreciation group gained 26.1% for the year (gross of fees; see table on page 4 for more complete information). The year was a pleasant reminder of how dicey it can be to try and time when investment gains are realized. We came into the year in the midst of a global commodity meltdown and a sharp double digit market decline. GDP growth slowed precariously and investors fixated first on the Federal Reserve raising rates and then on the election. We ended the year with the least predicated outcome of an election cycle in the past 70 years and the market hitting all-time highs. And our portfolios generated returns in one year that would be satisfactory to earn over three to five years.

2017 offers an equally muddled investment view. Once again I would argue that the most likely scenario is that the economy continues

to grow and that investors will continue to reap the benefits. Easy enough monetary policy and perhaps considerable fiscal stimulus are generally good conditions for economic growth. Employment numbers have been solid enough at an average of 200,000 jobs added per month. Household formations may be picking up, helping housing starts and general economic activity.

Also, we have worked through the difficult drag that was caused by the commodity recession. We are no longer cutting jobs in the energy space, but have started the process of adding both jobs and capacity. And just as the internet had a boom and bust cycle fifteen years ago, the energy industry has been going through something analogous. With the benefit of hindsight, there turned out to be some truth to the idea that the internet was going to change the world and contribute to economic development in a myriad of ways. The "energy revolution" -- with similar starts and stops – may prove to be an equally powerful long term engine for growth and transformation.

As for those who question the logic and therefore sustainability of the election "bump," I would go back to the argument I made in my last letter. It is not that markets are elevated because the candidate with a winning economic plan won. It is that markets were depressed while neither candidate had lost. The prospect of the election itself was constraining investors. It is almost comic to watch analysts now explain the market advance as a reaction to policy proposals rather than a relief that the process itself is over. As a result, I do not agree with those who argue "the market is overvalued because it is elevated on a misplaced confidence in new policy actions."

On the other hand, there are plenty of ways for things to go wrong for the economy and the markets. If monetary tightening gets ahead of itself (and more likely than not it eventually will), an economic slowdown will happen. And if the dollar rallies too hard, US Corporate earnings will suffer. Then there is always geopolitical risk (whether it is a Russian expansion in the Baltic States, or a nuclear weapon that goes off or just missing in Pakistan, etc) that may give us an unexpected jolt.

There is also the reality that every unproven Pres-

### TOP 10 HOLDINGS

1. Cliffs Natural Res. 6.25% Due 10-01-40
2. Boeing Company
3. Comcast cl A
4. American Express Co.
5. Corning Inc.
6. Chesapeake En. 5.75% Due 3-15-23
7. Rowan Company 5.4% Due 12-01-42
8. Maui Land & Pineapple Co.
9. Cisco Systems Inc.
10. Eli Lilly & Co

—As of 12/31/16—

*see notes on pg 4 for additional details

*Historically higher beta names have been the early drivers in our portfolios' recovery, with the more core-type holdings providing momentum later in the cycle. If that pattern holds this time, we could be in for another solid year.*

ident-elect inherently increases uncertainty. Beyond that, the unusual background and particular temperament of this President-elect -- and as important, his mandate to operate in a manner that is different than those before him -- ratchets that uncertainty up a notch or two. He captured the White House because the electorate is unhappy with the status quo. He was sent to Washington with a mandate to shake things up. A lot. And he seems to intend to. Changing that status quo may result in the benefits the electorate is looking for. But there could easily be some bumps along the way. Thinking we know how things will bounce from where we sit now seems irresponsibly overconfident. Who knows, it may be an experiment that works out just fine. On the other hand, managing assets will require keeping a watchful eye on how that experiment is going and being able to react appropriately to the myriad of possible outcomes.

Meanwhile, more and more investors are just turning on autopilot and indexing their equity exposure. A year ago we argued that the increasing degree of indexing was contributing to share prices trading at larger and larger variances to underlying values. I think some of our outperformance in 2016 resulted from our capturing the narrowing of some of those differences. (Ultimately I expect a good manager will benefit from the increasing volatility and inefficiency that indexing creates.) But the pace of indexing has not slowed. More and more capital is being committed to a mechanical process, and record numbers of active managers are closing. As a result, less and less discernment and expertise is brought to the investment process.

Given the reality of week-to-week and quarter-to-quarter market vagaries, our approach is straight forward. We put money to work in well valued assets that are positioned to earn fair returns over time. Despite a solid advance in 2016, I view our portfolio as chock-full of such investments. In fact the core names in our portfolio did little of the heavy lifting in 2016. I would argue that as a group they are more attractively priced at the year's end than they were at the beginning. A large majority of our returns in the year came from the higher volatility, smaller weighted, lower share price, lower market capitalization issues; names like Sprint, MBIA, Bombardier, Maui Land & Pineapple. Historically these higher beta names have been the early drivers in our portfolios' recovery, with the more core-type holdings providing momentum later in the cycle. If that pattern holds this time, we could be in for another solid year. Our continual review of these companies' financial statements suggest that there are plenty of reasons to be optimistic.

-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.

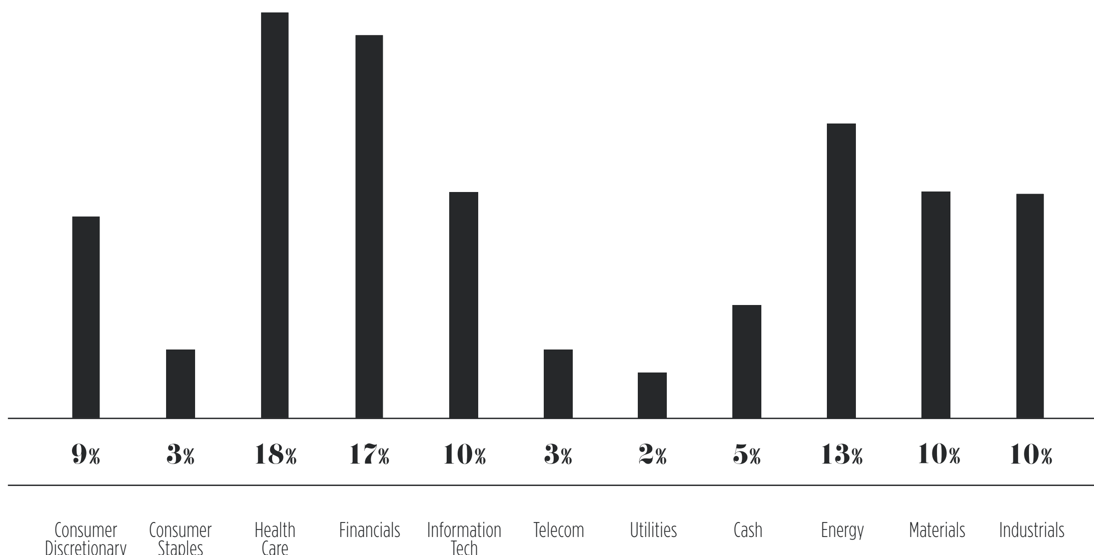
---

### *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.

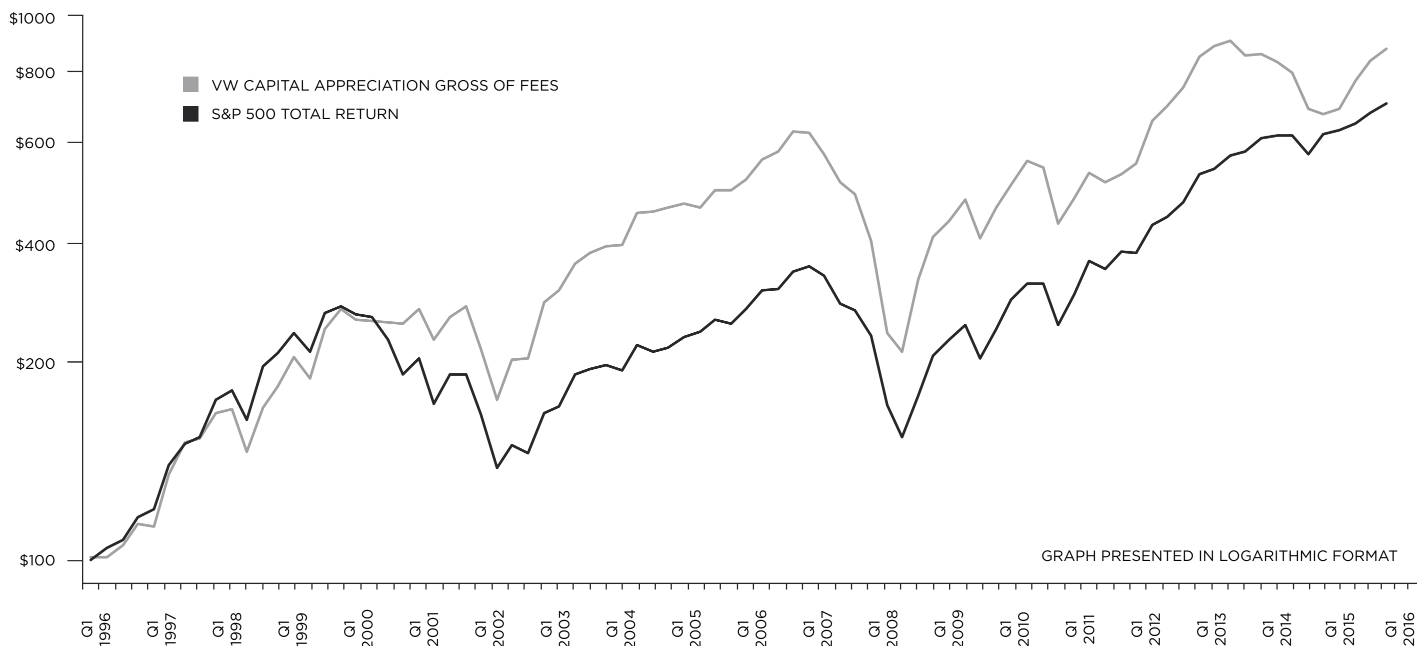
We enter investments that we view as 25 – 50% undervalued and sell them when we see them as fairly priced. Our anticipated holding period tends to be one to two years which results in only modest portfolio turnover.

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.

## PERFORMANCE REVIEW

**FOURTH QUARTER** SEPTEMBER 30, 2016 – DECEMBER 31, 2016




## TRAILING PERFORMANCE DATA

### VALUEWORKS' CAPITAL APPRECIATION COMPOSITE

| | GROSS OF FEES | NET OF FEES | S&P 500 TR |
|---|---|---|---|
| **2016 Q4** | 4.51 | 4.20 | 3.83 |
| **2016 YTD** | 26.12 | 24.62 | 11.98 |
| **1 year** | 26.12 | 24.62 | 11.98 |
| **3 years** | 0.89 | -0.35 | 8.89 |
| **5 years** | 11.26 | 9.89 | 14.67 |
| **10 years** | 4.01 | 2.68 | 6.91 |
| **Life*** | 9.35 | 7.77 | 8.35 |

*Life is 19.00 years (inception 1/1/1996)

### VALUEWORKS' BALANCED COMPOSITE

| | GROSS OF FEES | NET OF FEES | BLENDED INDEX* |
|---|---|---|---|
| **2016 Q2** | 2.30 | 1.94 | 0.35 |
| **2016 YTD** | 22.78 | 21.13 | 7.28 |
| **1 year** | 22.78 | 21.13 | 7.28 |
| **3 years** | 2.22 | 0.81 | 5.69 |
| **5 years** | 10.71 | 9.18 | 8.27 |
| **10 years** | 5.01 | 3.52 | 6.03 |
| **Life*** | 9.85 | 8.14 | 7.20 |

*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.**

ONE WORLD TRADE CENTER, SUITE 84-G NEW YORK, NY 10007 T: 212.819.1818 F: 212.819.1463 VALUEWORKSLLC.COM info@VALUEWORKSLLC.COM