ValueWorks
quality assets. compelling valuations.

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Volume 10,3 **Q3 2012**

We consider that the advances through September 30th (1) are quite satisfying for a nine month period, (2) make sense given the overall macro environment and (3) are consistent with our fairly bullish anticipation at the beginning of the year.

In a very mixed economic environment, the markets have continued to advance strongly. Investors waiting for improved conditions and robust economic growth before getting invested in equities are of course going to eventually commit at the market highs. After an extended period where cash underperforms and equities outperform, less disciplined investors will examine past performance and switch strategies. That is, of course, the most classic investment mistake. At Value-Works, we will diligently apply the same discipline all along the way, and expect our portfolios to have grown meaningfully well before we get to that eventual level of market enthusiasm.

In the meantime, the range of returns generated by the indexes this year has been remarkably wide. The Nasdaq 100 is up 22%. The Dow Transports is down 2%. The Dow Industrials is up 10% while the S&P 500 is up 14%. But in the face of those high – yet widely dispersed – returns, there has been much commentary, and lots of anecdotal evidence, that the great majority of active investors are not matching the index that they use as their benchmark. Rather, the best results have been generated by the indexes themselves.

This has contributed to the "hot-dot" investment theme of the day: Just Buy The Index. You see this in the massive growth of index-oriented ETFs. Index-oriented vehicles have seen significant capital inflows, while active managers have seen outflows. The best investment returns, and the bulk of investor capital allocation, has been to passive, static portfolios.

Given the ease with which the strategy can be implemented, the clear degree to which it has outperformed over the recent past, and the facile logic of the strategy, it is hard to argue with this "one-decision" investment program. And just as with any other investment strategy, the more that capital gets committed based upon past performance, the more it will outperform – until it doesn't. And until that reversal, investors being judged against such a hot dot strategy are of course faring poorly.

Top 10 holdings*:

1 **Williams Companies**
2 **American Express Co.**
3 **Calpine Corp.**
4 **Nokia Corp** 6.625% Due 05-15-39
5 **Xerox Corporation**
6 **Pfizer Inc.**
7 **Boeing Company**
8 **Eli Lilly & Co.**
9 **Paccar Inc.**
10 **3M Company**

—as of 09/30/12—

*see notes on p4 for additional Information

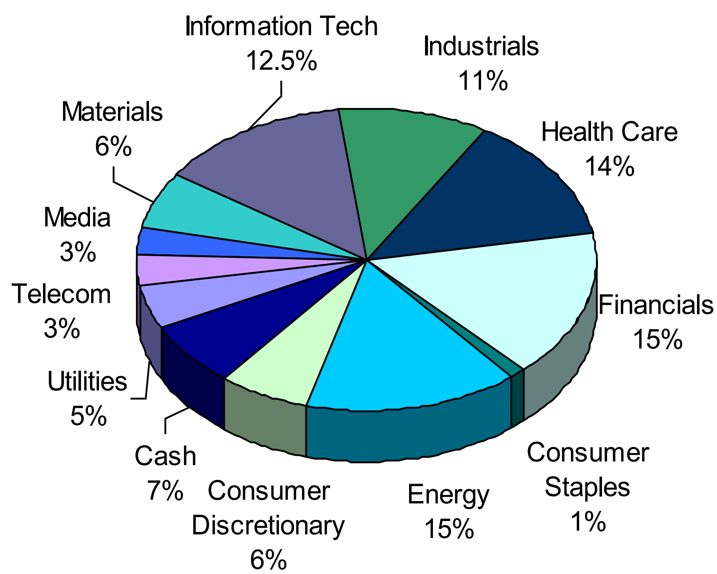
Just as investors became enamored of real estate and commodity related investments into the 2007 peak, cash and bonds into the market troughs of 2009 and 2002, and tech stocks in 1999, the most compelling past-performance has been generated by the indexes. At today's moment in time, "the indexes" are outperforming – and active managers as a whole are posting particularly weak relative past performance. Investors looking at that past performance (both over the past year or so, and from the market peak almost exactly five years ago) are shifting money out of the active investment discipline that created it.

There is a good possibility that such a decision represents a classic investment mistake. (I would note that five years ago, ValueWorks' past performance was stellar, and led to a flood of new assets at the top.)

Over time, it seems all of those simple and appealing "one-decision" investment strategies (those based upon a simple, single premise and past performance), end up disappointing investors. Ultimately, I see no substitute for using expertise, judgment, and discipline to navigate the financial markets. Such an approach does not mean you will not underperform over some periods. Rather, I consider it a fact that all good investment disciplines come with some periods in which they work less well than others. But I remain confident that using expertise and experience to identify good quality assets at compelling valuations will generate solid returns over time. I see our portfolio as ridiculously well stocked with such investments – from Hewlett Packard and Cisco, to Live Nation, Boston Scientific and the New York Times. I see many of these investments as so compressed in valuation, as Sprint was until very recently, that the upside could be truly explosive in many of these names.

— Charles Lemonides, CFA

Sector Diversification--
Capital Appreciation Composite



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