ValueWorks
quality assets. compelling valuations.

1450 broadway, 42nd fl
new york, ny 10018

phone: 212.819.1818
fax: 212.819.1463

info@valueworksllc.com
www.valueworksllc.com

Volume 11,2 **Q2 2013**

Financial markets were quite mixed in the latest quarter. Generally, US equities continued their advance, with the S&P 500 tacking on 2.9% in the quarter and 13.8% for the year. The Dow Industrials added 2.3% for the quarter and 13.8% for the year, while the Nasdaq composite respective gains were 4.2%, and 12.7%. However the bond market, precious metals and commodities, and non-US equities moved in the opposite direction. The yield on the ten year Treasury bond has recently risen to 2.5% from under 2.0%, translating to a principal loss of roughly 5%. Equities outside the US, as measured by the Dow Jones World Index, (excluding US) declined by 4.0% for the quarter. And this year to date, gold has lost more than a quarter of its luster.

This relative outperformance over the past nine months seems to be driven by security selection. There has not been a marked divergence between value versus growth that explains it, or large cap vs. small, or a great performing sector that we are overweight that drove the portfolios' outperformance. Rather, it has been a wide array of individual issues, ranging from Micron to Boeing to Live Nation, where what we perceived as a mispricing has now begun to correct itself.

This is starkly different than the period leading up to last September when there was remarkable similarity in returns of individual securities. Given the continued reliance upon index investing by so many investors, I see ample room for this trend to continue.

Top 10 holdings*:

1. American Express Co.
2. Calpine Corp.
3. Boeing Company
4. Micron Technology Inc.
5. Xerox Corporation
6. Nokia Corp. 6.625% Due 05-15-39
7. Williams Partners
8. Paccar Inc.
9. Pfizer Inc.
10. Cisco Systems Inc.

—as of 06/30/13—

Meanwhile, one should not underestimate the positive developments in the underlying economy. One of the largest imbalances – the US fiscal deficit – has been largely brought into balance over the past nine months. The fact that the economy has been able to grow (even modestly) as the deficit has been slashed, is a very important accomplishment. In fiscal year 2010 the federal deficit was $1.3 trillion. This year it is slated to come in at $642 billion, or 4% of GDP. This level approximates a sustainable, long term level. While there is plenty for all sides to criticize in how this was achieved, the reality is that the unsustainable amount of fiscal stimulus that was injected during the downturn has now been removed. The "sequester" sliced spending, the payroll tax was re-instated, and marginal tax rates were raised. These were very concrete, real drags to growth that have now been largely worked through. And through these adjustments the economy seems to have continued to expand at close to a 2% rate, and has continued to add close to 150,000 jobs per month.

Moreover, the progress at the federal level has been mirrored at the state level. California is projected to have a budget surplus, as are a dozen other states, all of which were much more precariously positioned a few short years ago. As the impact of that fiscal drag recedes into the past, it is quite reasonable to expect a re-acceleration in growth.

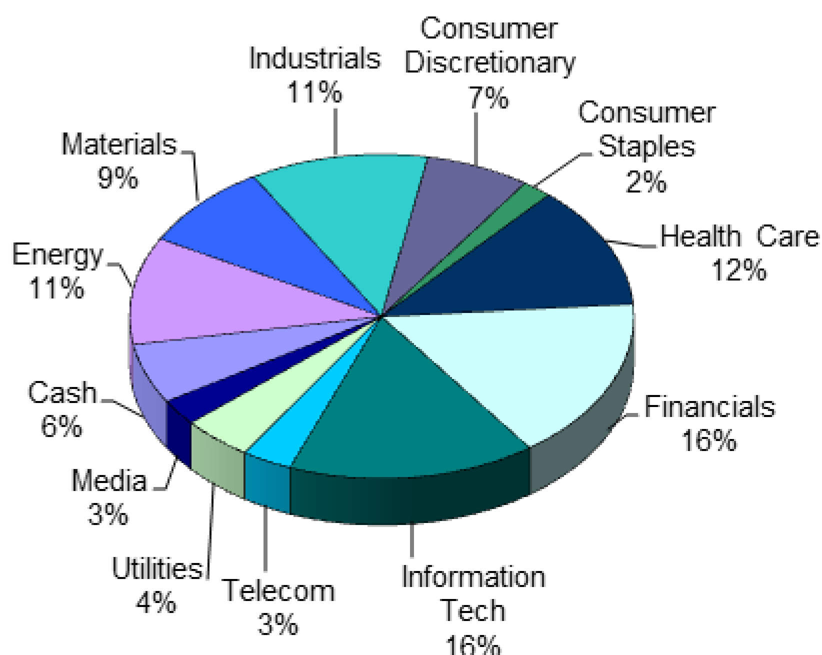
The key to a recovering economy has been the very stimulative policy of the Federal Reserve Bank. In the last quarter the market reacted sharply to fear that Fed policy may be getting closer to reversing direction. That concern deserves respect – Fed policy matters. Given the strong equity rally to that point, it makes sense that the market corrected based upon that concern. But I expect this to be more of a pause than a change in long term direction. The economic expansion has not reached anything near speculative excess. Unemployment is still way too high, and many cyclical parts of the economy are only now starting to recover. Housing seems to have bottomed, but it does not seem close to a top. If things go right, the Fed should slow down the rate at which it pumps more dollars into the system by this fall. But it may well be another couple of years before policy makers actually look to slow growth down. And once they start, markets may well ignore them for quite some time. If that plays out, this rally could last right through 2014.

In the last quarter we added Cliffs Natural to the portfolio. The stock has been marked down dramatically after being an investment darling during the commodity boom period.

While there may be further turmoil in commodity markets, iron ore pricing is likely to be near a bottom, and Cliffs is well valued relative to both cash flow and replacement cost, and is much lower priced than its peers (Vale, BHP Billiton, Rio Tinto, etc).

Overall we consider the positive developments in the portfolios to come largely as result of consistently applying our strategy and core principles through good times and bad. We will continue to look for opportunities where quality assets are being mispriced in the markets and continue to try to buy those assets at compelling valuations for your portfolio.

— Charles Lemonides, CFA



Contact:

ValueWorks LLC
1450 Broadway, 42nd floor
New York, NY 10018

email:
info@valueworksllc.com

Call us:

212 819 1818 (NY)
212 819 1463 (Fax)
866 567 4523 (Toll Free)

Visit us on the web:
www.valueworksllc.com