VALUEWORKS

QUALITY ASSETS COMPELLING VALUATIONS

VOLUME 12,4 FOURTH QUARTER 2014

The recent collapse in oil prices changes the dynamic for the global investment landscape in major ways. I anticipate the positive implications of this dramatic decrease in cost for a basic economic input to be quite far reaching and long lived for the broad economy and for most equities. That is especially true given that the oil price collapse seems to be part of a broader decline in commodity prices generally. Beyond that, there are solid reasons to suspect it is part of a much broader historical trend rather than an isolated, short term event.

But of course, near term the investment impact was not uniform. The large cap equity indices posted solid advances in 2014, driven by solid gains for the largest and "bluest chip" equities. Specifically, the S&P 500 advanced 13.7%, and the Dow added 9.9%. The narrow and large-cap bias of the advance is hinted at in the difference between these returns and the 5.7% advance for the S&P 600 small-cap index and the 4.2% gain in the Russell 2000 Value Index. But it is even clearer looking at the constituent parts of those indices. Six companies (Apple, Microsoft, Berkshire, Intel, Wells Fargo and Facebook) were responsible for 43% of the gain in the S&P 100 index. In 2013 the top six companies contributed 21%. The concentration was arguably higher in the S&P 500, where the top 6% of performers accounted for 56% of the advance.

After a very explosive 2013, our portfolios saw little overall change in value for the year; our Capital Appreciation group advanced .88%

for the year (gross of fees). Still, I consider it a productive year as the portfolio has been recharged with a wide range of very well valued opportunities. Some of these are new investments for the portfolio – Gilead Sciences and National Oilwell Varco representing very attractive valuations on very different types of assets. Other positions represent much better opportunities going forward because their prices have been stable while the values of their businesses have grown. A final group has greater potential now because their lower year end prices have created a much better risk/reward profile from these levels (the decline in these few securities largely offset the benefit the portfolio received in its exposure to the blue chip move noted above).

Oil prices have declined by well over 50% in less than four months. That is a stunning decline. That this move has happened over a period when there have been such trivial proximate causes makes it even more dramatic. The fact that prices had a similar decline a short five years ago (and from which they recouped significantly) could be read to imply that the present decline does not suggest a historic change. But I think that is fundamentally misleading – after all, the earlier decline was a small part of a larger cataclysmic event. This time? If there has been a net negative change in economic growth it has been extremely modest. A dramatic decrease in general global tensions could explain an oil price drop, but if there has been an historic decrease in global tensions over the past four months, I've missed it. To find another decrease like this one has to go back thirty five years, to the time of Jimmy Carter and Ronald Reagan; and at that point the decline in oil prices was part of an historic change in economic trends.

The 1970s and the 2000s were two periods when commodities were stubbornly expensive and the overall trend in prices was higher. They were also periods when equities indices had prolonged periods of overall stagnation. In sharp contrast, from the early 1980s through the 1990s, commodity prices declined, not only adjusted for inflation, but even in nominal terms. Specifically, the CRB commodity index rose from a base level

TOP 10 HOLDINGS

1. Xerox Corporation
2. American Express Co.
3. Boeing Company
4. Calpine Corp..
5. Paccar Inc.
6. Zimmer Holdings Inc.
7. 3M Company
8. Eli Lilly & Co.
9. Bombardier, Inc. cl B
10. Corning Inc.

—As of 12/31/14—

*see notes on pg 4 for additional details

"I consider it a productive year as the portfolio has been recharged with a wide range of very well valued opportunities."

of approximately 100 in 1969 to 330 in 1980, then drifted sideways to down, bottoming at 187 at the end of 1999. The next twelve years established a solid uptrend, with the index peaking at roughly 575 in 2011. Obviously, that broad generalization does not tell the whole story; but it supports the conclusion that there have been extended periods of rising commodity prices, and extended periods of flat to declining prices. And what we are seeing in commodity markets generally, and oil specifically, is quite consistent with the recent period of generally rising commodity prices being well behind us historically.

As the oil price sell-off began, there was a broad consensus that it would be modest and short lived. The general argument was that the “cure” for lower prices was lower prices; that lower prices would force higher cost producers to curtail production quickly enough to bring supply and demand back into balance, thus raising prices. And no doubt, there will be some of that that takes place. But one effect of a slowdown in drilling activity is a reduction in drilling costs; the price to rent rigs has come down, the price of steel pipe has come down, the prices of fracking sand and cement have come down, etc. Also, one of the biggest drivers of the growth in oil supply over the past decade has been the increase in efficiency in getting oil out of the ground. The time (and cost) it takes to drill a horizontal well has been driven lower year in and year out over the past fifteen years. And the amount of energy coming out has been growing dramatically. As a result of this technological improvement, the cost of getting oil out of the ground has been coming down even as the input cost (the steel pipe, cement, drilling rig rental, crew costs, etc) have been going up. Now that activity is slowing the price of all those inputs is falling and we can expect the technology to continue to improve, leading to a combined impact on reducing costs. Declining costs are rarely a harbinger of increased prices.

This changed environment will create both massive opportunities and massive challenges. No doubt the dislocation in the commodity sectors has already been very significant. Historically, we have uncovered many of our best opportunities as a sector goes from investor darling to investor outcast. Part of the reason our portfolios performed so modestly in 2014 was our exposure to this sector as that sell-off accelerated. The gains in other parts of the portfolio tended to offset those declines, but we now have some investments priced in a way that provides very meaningful upside from year-end levels. We expect that more opportunities will develop as this theme plays out and prices continue to decline. Because we have only modest exposure at this time, we consider ourselves well positioned to exploit this dislocation, and are quite optimistic about the opportunities that are being created in this sector.

As mentioned above, we expect a period of declining commodity prices to be very positive for economic growth generally, and for equities investors specifically. Given that over 80% of our portfolio is invested in non-commodity oriented companies, we view the spillover benefit of low commodity prices as even more important than the opportunities created in the commodity space. Low and declining input prices allow for an extended period of growth without inflation, and improved profit growth and margins for the rest of the economy. It may even allow for a combination of profit growth and wage growth, driving further economic improvement.

In short, we see the economic and investment environment as having gone through some very important changes in the past year. The themes and sectors that worked over the recent past are not likely to be the same themes and sectors that work well over the next several years. While our portfolios showed little overall change in value in 2014, we nevertheless consider them much better positioned to participate in the opportunities that have been and will be created as these changes play out.

-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*

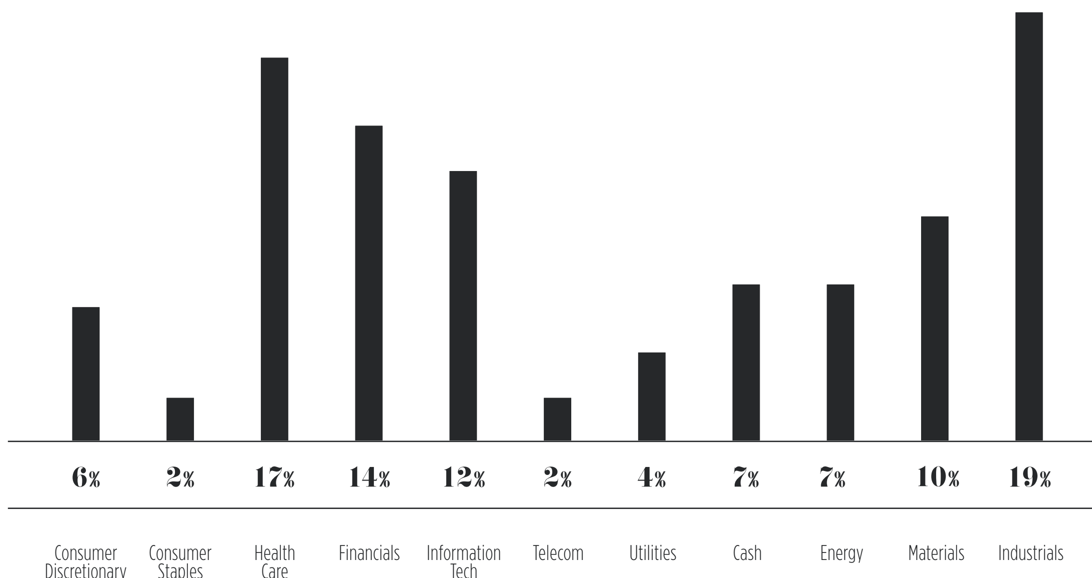
We exit a position when a security either reaches full valuation or changes in its outlook invalidate part of our original thesis.

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.

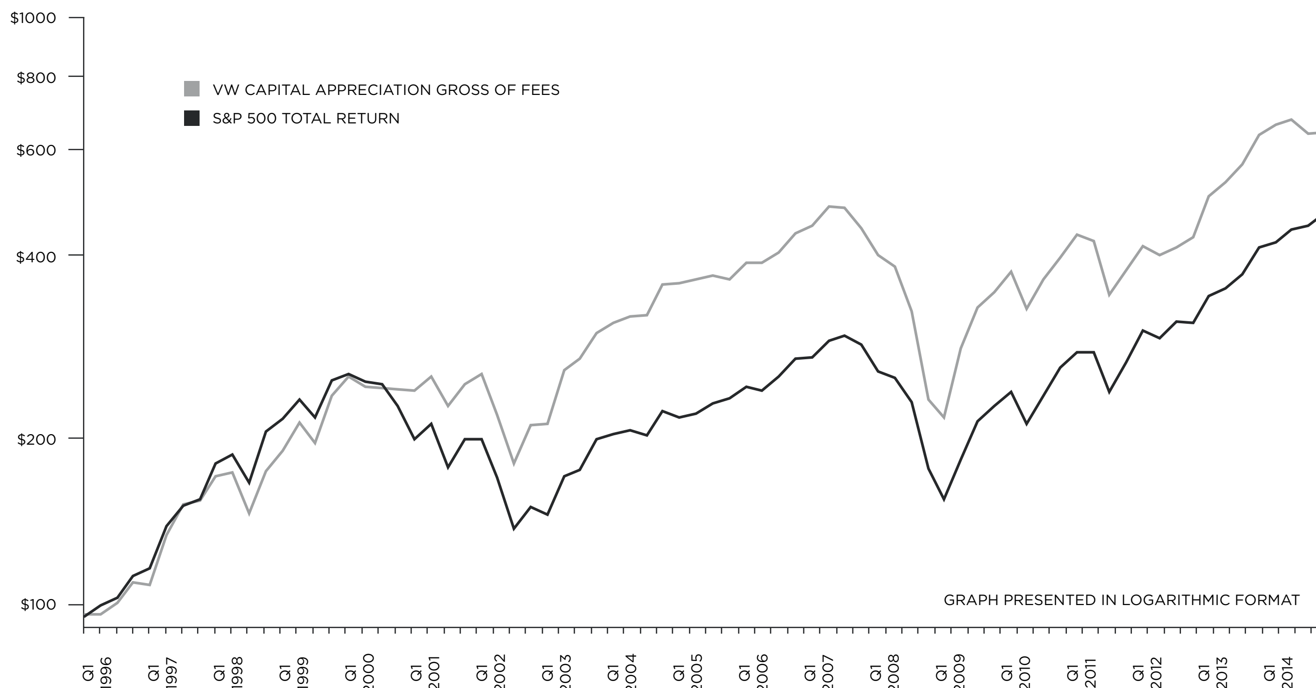
Because our decisions are based on research and sound fundamentals we view depressed price action on our securities as buying opportunities rather than sell signals.

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 SEPTEMBER 30, 2014 – DECEMBER 31, 2014



TRAILING PERFORMANCE DATA

VALUEWORKS' CAPITAL APPRECIATION COMPOSITE

	GROSS OF FEES	NET OF FEES	S&P 500 TR
2014 Q4	0.84	0.52	4.93
1 year	0.88	-0.36	13.68
3 years	18.76	17.29	20.41
5 years	12.69	11.25	15.39
10 years	5.84	4.45	7.64
Life*	10.28	8.66	8.54

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

VALUEWORKS' BALANCED COMPOSITE

	GROSS OF FEES	NET OF FEES	BLENDED INDEX*
2014 Q4	1.64	1.27	3.39
1 year	4.92	3.45	8.84
3 years	17.77	16.14	11.11
5 years	12.09	10.53	10.07
10 years	6.75	5.21	6.57
Life*	10.84	9.09	7.53

*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.

As of 12/31/2014 the Capital Appreciation Composite consisted of 142 accounts and $94,649,934 in assets; while the Balanced Composite consisted of 53 accounts and $42,446,625 in assets. Together this represents 98.48% of total accounts and 59.24% of total assets.

1450 BROADWAY, 42 FL, NEW YORK, NEW YORK 10018 T: 212.819.1818 F: 212.819.1463 VALUEWORKSLLC.COM info@VALUEWORKSLLC.COM