VALUEWORKS
QUALITY ASSETS COMPELLING VALUATIONS

VOLUME 14,2 SECOND QUARTER 2016

The market environment from mid-February has favored our investment style. We are in a period where valuations increasingly matter. Price action is being driven by more than just momentum and perceived quality. That represents a big change from the preceding year and a half. And that is reflected in our investment results. Not only is the portfolio up sharply over this stretch, it is meaningfully outperforming the indices. As the tables at the back of this newsletter show, we are generating substantial investment returns while the broad markets are nearly unchanged.

Specifically, our Capital appreciation Group of accounts is up 12.3% YTD and 10.2% for the quarter (gross of fees), while the Dow is up 2.90% for the year, 1.38% for the quarter. The comparable S&P 500 results come in at 2.69% and 1.90%, while the Russell 1000 Value stands at 4.89% and 3.91% for the year and quarter, respectively. Our outperformance is in sharp contrast to our relatively poor performance last year.

For approximately two years through mid-February, the market environment was one in which fully priced, investor adored securities moved ever higher to increasingly over valued levels while non-anointed instruments slid to levels increasingly divorced from underlying asset values. Our approach during that period was to decrease exposure to issues as they became over-extended and build exposure to those securities that were becoming increasingly scorned. Our portfolios underperformed as those valuations became more extreme.

Those trends have since reversed. The "nifty-fifty" type equities have largely stalled and retreated. On the other side, many of the stocks and bonds that were being discarded have had meaningful percentage gains from their lows. Given the extreme valuation levels securities traded to, and the trend-reinforcing nature of a market dominated by indexed investors, we may be at the very early stages of this trend. Market chatter presently rotates around two broad questions: what is the macro outlook from here (in other words, what is the outlook for economic growth), and are equities generally priced richly or poorly given those conditions.

On the economic front, I question whether it is credible to have great confidence in how people, and then the economy, will react to the events that will be unfolding in the months ahead. It is easy to see how things could go badly, and be paralyzed as a result. But it also seems possible that things could go much better.

The notion of the United Kingdom leaving the European Union sent markets spinning over the past two weeks. Investors have focused on the real possibility that the separation will chill decision making and make doing business across Europe harder, thereby stalling economic activity. That may be how it plays out. On the other hand, the fact that the pound has devalued automatically lowers the cost of doing business in London, increasing the City's competitiveness as a global financial center. Beyond that, the UK's ability to put a more flexible and competitive regulatory structure in place, as opposed to a more rigid model imposed across the European Union, could provide a big boost for economic activity. A more flexible regulatory system and a more responsive governing structure in the UK should prod the EU to move further in that direction in order to meet the increased competitiveness of the UK. It should be noted that the status quo across Europe leaves plenty of room for improvement. If Brexit sparks change, there are plenty of ways the change could be for the better.

The European and Japanese central banks are pushing their interest rates into historic negative territory while the US central bank is conflicted about increasing rates. The twenty-year Japanese government bond has a negative yield. So does the Swiss thirty year bond and the German ten year bond. These are uncharted waters. This situ-

TOP 10 HOLDINGS

1. Cliffs Natural Res. 6.25% Due 10-01-40
2. Boeing Company
3. Boston Scientific Corp
4. Eli Lilly & Co.
5. Comcast CL A
6. Maui Land & Pineapple Co.
7. Cisco Systems Inc.
8. Corning Inc.
9. Pfizer Inc.
10. Rowan Company 5.40% Due 12-10-42

—As of 6/30/16—

*see notes on pg 4 for additional details

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ation is clearly being orchestrated in order to stimulate growth. It may work. But given how unprecedented this situation is, it is surely hard to have complete confidence in how events will unfold.

On the domestic front, the Presidential election is unhandicapable. Anyone who approaches this with a certitude that they know how it will play out and how the markets and economy will react is seriously overreaching. Surely, there are many strong feelings about it – mostly focused on how badly things could go if the wrong candidate is elected. But such a confidence in the economic upheaval that will tautologically result from the success of either candidate is not borne out by historical experience. There have been instances, both in the US and around the world, where economies and markets that have done both very well -- and very badly -- under either leadership framework; if not for their entire governing experience, at least for a number of years.

Against that backdrop, the broad market trades at a fairly rich multiple of better than 18 times trailing earnings, and has had earnings decline for five straight quarters. But that overview misses important details below the surface.

The large capitalization part of the market can be parsed in the following way: (1) Energy and Commodity companies that are trading at infinite multiples because the earnings have gone to zero as oil and commodity prices have declined, (2) super-stable and high growth companies that are also trading at very extended multiples (28 times for Clorox and 71 times for Facebook), and (3) a wide range of high quality, economically important companies that are trading at 8-14 times earnings that make up the core of our portfolio. While the index at 18 times may seem rich, I would argue that from a bottom-up perspective, most individual securities in the first and third group are attractively priced, and given current interest rates, a case can be made for a fairness of pricing for most of the second group. Looked at in that light, there may well be room for a 20 plus percent upside move in the broad market.

The right strategy during this period of uncertainty is to remain prudently invested. If, as most often happens, we navigate this period without a major negative development, a relief rally can be ignited by the most subtle and random event. Such rallies can be fast and furious, and emerge from seemingly out of the blue. Those not invested ahead of that moment will never capture those gains.

On the other hand, if the less common but more memorable (for its extraordinary nature) market dislocation occurs, we will once again reposition the portfolio along the way, increasing exposure in whatever areas the dislocation creates the biggest valuation mismatches. And once the foul-weather has passed, we should not only recoup the declines as conditions stabilize, but benefit from the adjustments we make during the storm.

So even given the variability of the possible outcomes, our portfolios are anchored around a core of major US companies with powerful market positions that are trading at very fair valuations, and augmented with a diverse group of more aggressive issues trading at very discounted valuations. That second, more aggressive group of holdings has had a powerful move from the February lows. We were well served building on that exposure in the first quarter. Still, the great bulk of these continue to trade at levels below where we first considered them attractive, suggesting to me very meaningful potential upside. We have seen this type of market moment before, and it has tended to resolve itself with a powerful advance in the portfolio.

-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*

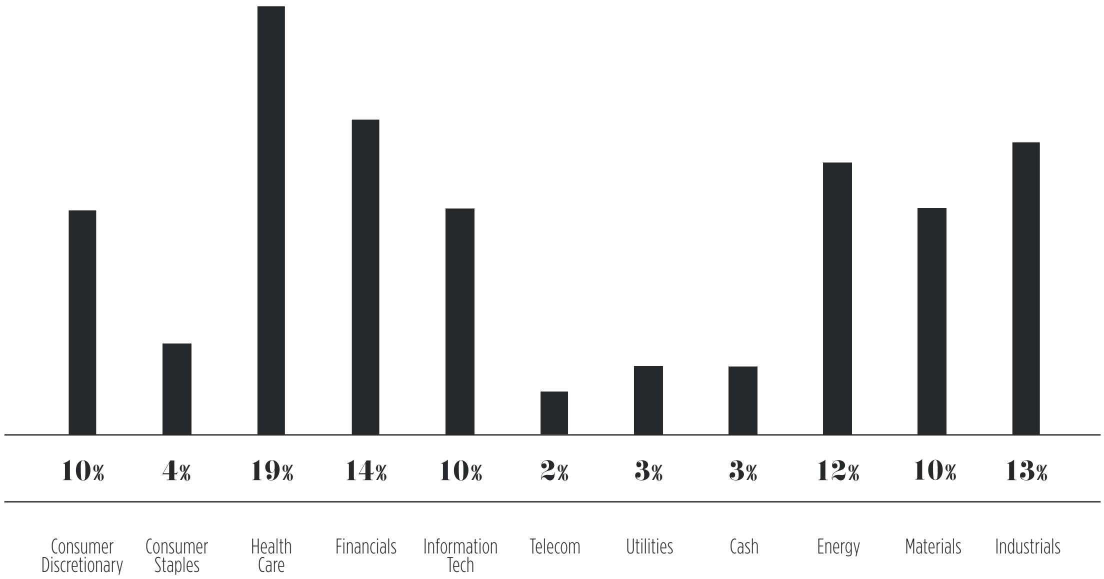
We exit a position when a security either reaches full valuation or changes in its outlook invalidate part of our original thesis.

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.

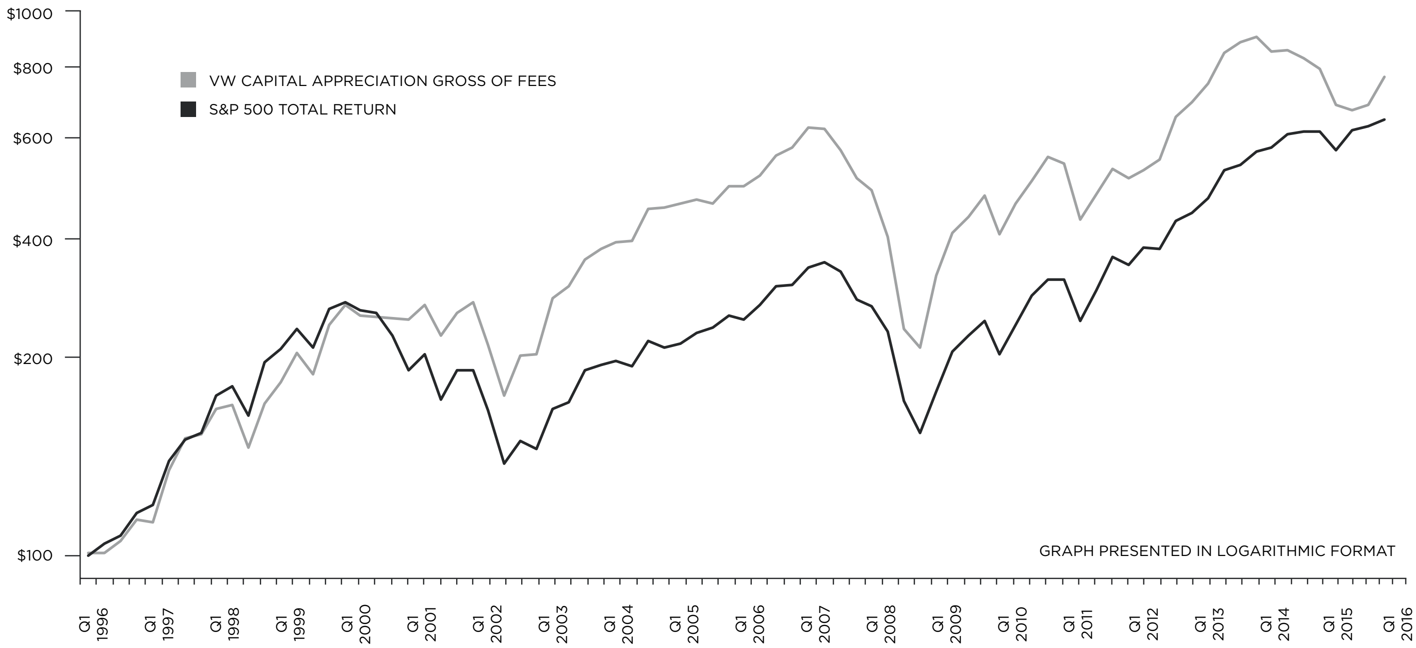
Because our decisions are based on research and sound fundamentals we view depressed price action on our securities as buying opportunities rather than sell signals.

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

FIRST QUARTER MARCH 31, 2016 – JUNE 30, 2016



TRAILING PERFORMANCE DATA

VALUEWORKS' CAPITAL APPRECIATION COMPOSITE

	GROSS OF FEES	NET OF FEES	S&P 500 TR
2016 Q2	10.20	9.89	2.46
1 year	-3.09	-4.27	4.02
3 years	3.04	1.77	11.67
5 years	6.35	5.03	12.04
10 years	3.94	2.60	7.39
Life*	8.97	7.39	8.16

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

VALUEWORKS' BALANCED COMPOSITE

	GROSS OF FEES	NET OF FEES	BLENDED INDEX*
2016 Q2	9.48	9.12	2.38
1 year	-1.08	-2.41	5.25
3 years	4.30	2.86	7.60
5 years	6.63	5.16	7.95
10 years	5.07	3.57	6.67
Life*	9.61	7.90	7.26

*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.
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