TOWLE & CO.

DEEP VALUE INVESTING

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To: Investors

"I don't believe what I just saw!" shouted Baseball Hall of Fame broadcaster Jack Buck following a game winning homerun in the 1988 World Series. Jack's comment reflects our reaction to the price advance of the Towle portfolio since Election Day. From November 9th to year end, the portfolio surged 22.8% before fees, making it one of the largest, short-term advances in our history. "Nobody saw it coming." (*Barron's*, December 19, 2016) While few analysts predicted a Trump victory, the run-up in global equities was completely unexpected. Political pollsters and popular opinion can be wrong. Oh, how difficult it is to predict the near-term future!

2016 ends on a happy note of exceptional performance for our deep value strategy. Returns for the Towle Deep Value Composite (DVC) and customary benchmarks are noted below with periods greater than one year annualized.

Periods ending 12/31/16	Towle DVC *(Gross of fees)*	Towle DVC *(Net of fees)*	Russell 2000 Value	S&P 500 Total Return
3 months	20.80	20.58	14.07	3.82
1 year	57.18	56.11	31.74	11.96
3 years	11.54	10.75	8.31	8.87
5 years	21.62	20.79	15.07	14.66
10 years	9.87	9.05	6.26	6.95
20 years	14.19	13.36	9.71	7.68
30 years	14.35	13.53	11.01	10.16
Inception (1982)	16.88	16.05	12.35	11.50

Our year end letter segments as follows: **2016 Portfolio Review** and **Looking Ahead**.

2016 Portfolio Review

This section has been removed for compliance reasons to exclude discussing specific securities transactions.

Looking Ahead

Stock market prices are full, pushing toward historically high valuations. Various analysts suggest the U.S. economy is headed toward an inflection point of accelerating GDP growth, supporting today's equity values. The key issue is whether or not the stock market is already reflecting the likelihood of improving economic conditions. How should one respond to today's lofty equity valuations and the complex issues facing the global economy?

Political Shift and Federal Stimulus

Without a doubt, the recent elections bring a political shift from Federal Government administrative control to a greater emphasis on the private sector. This shift has been sudden and surprising. The financial markets now anticipate this new posture will encourage capital investment by corporations and households alike. However, if history is a guide, the private sector will eventually succumb to overheating and extended valuation. Then, the Federal Government will once again intervene to reign in the excesses. The pendulum of political power swings between the forces of control and excess.

The Great Recession ended in February 2010. However, the economic rebound has been weak, posting a below average annual GDP gain of 2.1%. In the four years following the last four recessions, GDP growth recoveries have averaged 4.2%. The Republican-controlled government plans to reignite U.S. GDP growth through a series of tax cuts, deregulation, and fiscal stimulus measures. Lower tax rates may assist business formation and appropriate risk taking. Burdensome regulations may be reduced or eliminated. Infrastructure spending will likely increase.

Conversely, the Republican recovery plan may not work as designed. A series of economists conclude that the U.S. is growth restrained. The slowing productivity of today and the aging demographics of tomorrow may simply limit economic output. "We are living in an age of diminished expectations….." (*Bloomberg Businessweek*, November 3, 2016) Uncertainty abounds, but one can logically conclude that the policy changes contemplated will likely generate additional economic activity for the U.S. economy.

Economic Stability and Growth
Someday there will be another recession, but it's difficult to predict the next downturn based on current economic conditions. "Economies don't die of old age, they die of excesses—overbuilding, overconfidence, overspending," claims John Canally of LPL Financial. (*Kiplinger Finance*, January 2017)

While stock market valuations seem stretched, the economy appears well balanced, sidestepping the unfavorable elements that foster excesses or recession. The consumer is in good shape as demonstrated by numerous indicators. Wages are accelerating at a moderate pace. Consumer confidence is strong and trending up while spending remains measured and cautious. Single family housing starts stay below historic norms, a positive for pent-up demand. While increasing in recent years, consumer debt is under control. The Household debt-to-service ratio approaches a 36 year low. (*Wall Street Journal*, October 27, 2016)

The corporate sector of the economy is in good shape as well. Commodity related producers are slowly returning to profitability following horrendous product price declines. Most U.S. companies, realizing attractive profit margins for a number of years, possess financial flexibility and the wherewithal to invest as appropriate. As measured by the S&P 500, earnings are improving following six quarters of decline.

An environment of climbing interest rates and higher inflation typically limits economic growth, but these constraints may partially work in reverse for the present-day economic cycle. Rising interest rates are in the early stages of normalization, a sign of confidence, benefitting savers and financial institutions. Although inflation moves upward, it remains in line with the Fed's 2% target. Even though the U.S. unemployment rate is below 5%, underutilized manufacturing capacity across the globe may prevent runaway cost-push inflationary tendencies. Manageable inflation and right-sized interest rates are critical to perpetuate economic growth in the U.S. In summary, the U.S. economy currently demonstrates solid footing and continued strength.

Stock Market Ebullience
The U.S. stock market has already priced in much of the good news regarding federal policy change and projected economic growth. As previously stated, valuations are extended! The Rule of 20 is closely watched by the Towle investment team. A reading markedly above 20 suggests concern. Here's a year-end historical snapshot of the Rule of 20:

Rule of 20 (Value Line P/E + Inflation)					
2011	2012	2013	2014	2015	2016
17.8	17.2	19.7	20.0	17.9	21.5

As we've highlighted in previous letters, the following stocks exemplify today's fully valued equity market. These companies are steady performers with consistently strong profit margins. Please note below that the group's P/E ratios are greater than 20x, representing an earnings yield of less than 5%.

12/31/2016	*Price ($)*	*P/E (x)*	*5yr Adj. Net margin (%)*		*Adj. Net Margin (%)*
			Low	***High***	***Current***
Colgate-Palmolive (CL)	65.44	23.3	13.6	14.6	14.6
Fastenal (FAST)	46.98	27.5	12.5	13.4	12.5
Illinois Tool Work (ITW)	122.46	21.8	9.6	13.1	13.1
MasterCard (MA)	103.25	27.5	32.4	34.6	32.4
Nestle (NSRGY)	71.74	21.3	9.5	14.6	9.5
Sherwin Williams (SHW)	268.74	21.8	6.0	8.8	8.8

Source: Capital IQ

Over the long haul, stock prices are driven up or down based on earnings. Profit margins are a major component of earnings, and corporate profit margins are elevated, close to historic highs. The combination of high profit margins and high valuations (P/Es), as confirmed by the companies listed above, would advocate that investors temper their expectations of future equity returns.

The Towle Portfolio
Our recent quarterly letters highlighted the irrational valuation gap that existed between our deep value portfolio and the broader stock market. Over the last few months, this gap has narrowed substantially. That said, we believe the Towle portfolio still possesses uncaptured value. While the "easy money" has been recognized, there is solid rationale for our holdings to advance toward their three-year sell targets.

ACME, our internally generated investment monitor, paints a generally supportive picture. Although Asset Valuation flashes negative, the other three categories remain encouraging: Cost of Capital, Market Dynamics and Economic Conditions. We conclude from ACME and from the experience of our investment team that the current investment environment creates satisfactory conditions from which our portfolio companies can post good results. However, as equity prices push closer to sell targets, we will not hesitate to sell. And, if the deep value opportunity set doesn't improve, the Towle portfolio could hold a meaningful cash position at some point in 2017.

When managing capital for others, we believe a disciplined process and a confidence in economic progress are critical components to investment success. At Towle & Co., we adhere to a deep value investment strategy that has worked well for many years. Although we recognize the uncertainty of today's environment, we remain positive about the future and echo the thoughts of Jason Zweig, "Without a saving faith in the future, no one would ever invest at all. To be an investor, you must be a believer in a better tomorrow." (*Intelligent Investor*, Harper & Row)

We strongly encourage investors to cling steadfastly to those investment strategies that work over the long run. An impatient and impulsive approach often does not provide the desired results. In the prosperous and satisfactory investment arena of today, we are always grateful and appreciative of your support and commitment. Your inquiries and questions are welcomed, as always.

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