

# TOWLE & CO.

DEEP VALUE INVESTING

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July 12, 2018

Press on! While year-to-date results for the Towle Deep Value Composite (DVC) disappoint, we are more upbeat regarding the portfolio's appreciation potential than we were in the early days of 2018. Heightened uncertainty around interest rates, inflation, and U.S. trade policy weighed on investor sentiment in the second quarter, but we remain comfortable with our sell targets and fully invested given the continued strength of corporate profits and the momentum of the U.S. economy.

Our past performance is provided below. Results are annualized for periods greater than a year.

Periods ending 6/30/18	Towle DVC (Gross of fees)	Towle DVC (Net of fees)	Russell 2000 Value	S&P 500 Total Return
3 months	5.04	4.85	8.30	3.43
6 months	-4.54	-4.88	5.44	2.65
1 year	12.91	12.14	13.10	14.37
3 years	13.36	12.57	11.22	11.93
5 years	14.05	13.25	11.18	13.42
10 years	13.53	12.71	9.88	10.17
20 years	12.24	11.42	8.67	6.46
30 years	14.39	13.57	10.82	10.35
Inception (1/1/82)	16.46	15.63	12.21	11.68

*Past performance is no guarantee of future outcome. Refer to the last page for additional disclosures.*

The second quarter letter breaks out as follows: **Investment Environment**, **Portfolio Review**, and **A Steady Hand**.

## **Investment Environment**

Economic and political concerns are plentiful. Trade tensions, an unsettled immigration policy, and rising discontent amongst our allies cause much consternation. Inflation of 2.8% is the highest reading since 2011, a potential headwind for price-to-earnings multiples. The Federal Reserve Bank continues to normalize interest rates while the World Bank reduces global growth forecasts for 2019 versus 2018. Last but not least, an out-of-control federal budget places the U.S. government in an untenable position, elevating anxiety for many market participants.

Despite these political risks and macro issues, we believe a fundamentally favorable business environment upholds economic progress:

- **Current economic expansion marches on.** The Conference Board Leading Economic Index continues to post a robust reading.
- **Consumer and business optimism stays robust.** The University of Michigan Consumer Sentiment Index neared a 14 year high at the end of the second quarter. The National Federation of Independent Business's Small Business Optimism Index approached its 45 year record high.
- **Economic excess is not prevalent.** Prices and underlying demand for most products and services appear reasonable. The economy looks balanced.

While valuations remain full for many equities, an attractive environment prevails. We will not hesitate to invest in new positions that meet our strict purchase requirements.

## Portfolio Review

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

## A Steady Hand

Change is a constant in the human experience. Many public companies come to market and then disappear due to M&A activity or bankruptcy. In the 1990s, numerous discount department stores such as Bradlees, Caldor, and Venture traded publicly on U.S. stock exchanges. Today, most of these companies no longer exist, driven out by the efficiency and innovation of Target, Walmart, and Costco. Over time, this constant change brings fresh perspective and new areas of interest to the deep value investor.

Accordingly, the Towle portfolio has changed materially over the last three years, but the underlying strategy remains the same. Our consistent approach to deep value investing provides a timeless framework for navigating the variability of market conditions and investment opportunities. We simply respond by selling or buying securities.

The following excerpt from our investor letter of July 10, 2015 provides four key requirements for maintaining a steady hand in this constantly changing environment:

1. **Take a three year view.** Much to the positive can occur within a three year time horizon. Industry activity may alter dramatically. Managements can rearrange assets and implement productive change.
2. **Price is king.** Our valuation metrics dictate a discounted price. We purchase when others are disposing. Such action provides a margin of safety and noteworthy appreciation potential.
3. **Seek an inflection point.** Our analytics designate a turn in earnings or industry conditions within our investment horizon.
4. **Stay the course.** Entering our 34<sup>th</sup> year, we recognize the need to be persistent in pursuing our strategy, day in and day out. We will not compromise or alter the process.

This statement from yesteryear applies to the current investment scene. Enduring investment strategies carry on, unfazed by time and events. While economic conditions in the U.S. remain upbeat, we fully recognize these ideal circumstances won't last in perpetuity. How or when the next downturn begins is unknown. Until we see a reason to be more defensive, we stay the course striving to continuously improve our deep value investment discipline.

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In closing, we are delighted to announce the following personnel changes at Towle & Co.

On the eve of his 10<sup>th</sup> anniversary at the firm, Joe Bradley has been promoted to the newly created position of Chief Operating Officer and Director of Client Relations. In this role, he will direct all non-investment related aspects of the business and serve as the primary liaison to our outsourced consultants. Given Joe's work ethic, pleasant demeanor, and strategic mindset, we all stand to benefit from his increased responsibility and operational leadership.

Following the completion of his MBA at Columbia University in May, Luke Barthelme accepted our invitation to join Towle & Co. as an Analyst, effective June 1<sup>st</sup>. He is a non-voting member of the investment team with a current focus on developing efficiencies in our deep value investment process and research management platform. We are very pleased to welcome Luke's high caliber thought, technical skills, boundless energy, and passion for investing.

As we journey through our 37<sup>th</sup> year of money management, we must pause to express gratitude for all the ways our investment process has brought meaningful growth and fulfillment to hundreds of investors.

J. Ellwood Towle  
Christopher D. Towle  
Peter J. Lewis, CFA  
James M. Shields, CFA  
Wesley R. Tibbetts, CFA

**DISCLOSURES**

1) Performance results are calculated using a time-weighted total-rate-of-return method and are expressed in U.S. dollars. Results include the reinvestment of all income. Gross of fee performance is presented as supplemental information and reflects the deduction of all trading expenses, except in those accounts where ABP (Asset-Based Pricing) fees are assessed in lieu of standard trade commissions. Net of fee performance was calculated using actual management fees and ABP fees. 2) Although Towle & Co. makes no attempt to manage against the composition of a specific benchmark, the Firm provides the Russell 2000 Value Index as a readily accessible indicator of comparative small cap performance as well as the S&P 500 Index as a general indicator of the market at-large. The performance of an index is not an exact representation of any particular investment as one cannot invest directly in an index and investments made by Towle & Co. differ in comparison to the Russell 2000 Value Index in terms of security holdings and industry weightings. Towle & Co. invests in considerably fewer companies than either index with lower average multiples to book value, sales, earnings, and cash flow, and as a result, the volatility and returns of the indexes may be materially different from the individual performance attained by a Towle & Co. investor. 3) Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. Unless otherwise noted, references to 'the Towle Portfolio' or 'the Portfolio' refers to a representative, fully discretionary portfolio managed in the Towle Deep Value strategy and member of the Towle Deep Value Composite. 4) Opinions expressed are those of Towle & Co. and should not be considered a forecast of future events or a guarantee of future results. Opinions and estimates offered constitute our judgment as of the date set forth above and are subject to change without notice, as are statements of financial market trends, which are based on current market conditions. All material presented is compiled from sources believed to be reliable, but no guarantee is given as to its accuracy. 5) CFA® is a designation issued by the CFA Institute. To earn the designation, candidates must pass three course exams, each requiring approximately 250 hours of self-study, and have completed four years of qualifying work experience.