TOWLE & CO.
DEEP VALUE INVESTING
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Steep decline! While it's difficult to pinpoint the exact reason for the stock market's outsized sell-off in late 2018, we surmise that investor anxiety relating to trade talks with China and the Federal Reserve's monetary program played leading roles. This policy uncertainty, combined with elevated equity valuations, rising recession fears, and heavy tax loss selling, created fertile ground for a stock market breakdown.

Our portfolio of economically sensitive deep value equities was not immune to this broad-based risk-off environment. The Towle Deep Value Composite (DVC)ended 2018 with a decline of 30.9%, our third worst year on record eclipsed only by the Savings & Loan Crisis (1990) and the Great Recession (2008). Significant drawdowns are characteristic of our deep value investment process and typically offer an abundance of new investment candidates. This was unmistakably the case in the fourth quarter. With no immediate recession in view, strong labor markets, and core inflation of just 2.2%, the Towle investment team firmly believes that current equity pricing is <u>not</u> a true reflection of the underlying worth and inherent earnings power of our portfolio.

Past performance is noted below. Results are annualized for periods greater than a year:

Periods ending 12/31/18	*Towle DVC (Gross of fees)*	*Towle DVC (Net of fees)*	*Russell 2000 Value*	*S&P 500*
3 months	-29.79	-29.94	-18.67	-13.52
1 year	-30.91	-31.49	-12.86	-4.38
3 years	7.98	7.19	7.37	9.26
5 years	2.14	1.39	3.61	8.49
10 years	16.36	15.53	10.40	13.12
20 years	11.41	10.59	8.23	5.62
30 years	12.94	12.13	10.10	9.97
Inception (1/1/82)	15.20	14.38	11.46	11.30

Returns are preliminary and subject to change. Past performance is no guarantee of future outcome.
Please refer to the last page for additional disclosures.

Portfolio Update

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

Outlook

Today's society favors short term results. In an article from April 2, 2011, *Wall Street Journal* staff writer Jonah Lehrer rebuked this short term mentality: "It turns out that many of the most important factors for life success are character traits, such as grit and self-control, and these can't be measured quickly." In this light, the Towle investment team is dedicated to making reasonable long-term investment decisions for the benefit of all our clients. Thus, we will not be disturbed by short-term events. From our view, the Towle portfolio is undervalued and underappreciated, providing a reasonable window for the addition of long term capital.
That said, we acknowledge numerous concerns rattling today's investment community:

1. Slowing global growth and the threat of U.S. recession.
2. Difficult negotiations with China, a major trading partner.
3. High levels of federal and corporate debt throughout the world.
4. The evolving trajectory of monetary policy.

For now, these macroeconomic and geopolitical headwinds do not appear insurmountable. In our letter from October 11, 2017, we quoted an astute market forecaster, Sam Stovall, regarding the threat of a recession. In his analysis, Sam provided four forecasting trends that could "tip the scale" toward an economic difficulty: housing starts, consumer sentiment, Index of Leading Economic Indicators, and the yield curve. (*Kiplinger's Personal Finance*, October 2017) Similar to 15 months ago, none of these indicators point to a recession in overall economic activity at the current time.

As you know, the Towle Deep Value investment discipline centers on low price-to-sales securities with projected earnings equating to a 15% return on market value within three years. Hence, a low forward price-to-earnings (P/E) ratio based on the "normalized" earnings power of a company is absolutely critical to our process. Currently, in our view, the investment community fails to assign a reasonable earnings multiple (P/E) to our portfolio. According to consensus estimates from Capital IQ, the Towle portfolio's median P/E for 2019 is 5.9x equating to an earnings yield of 16.9%. History suggests that our portfolio should be valued at a P/E closer to 10x. So, we press on, anticipating that the "good works" of our stock selection process and the historical return advantage of our deep value space will shine brightly in the future.

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DISCLOSURES

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