

TOWLE & CO.

DEEP VALUE INVESTING

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Encouraging! The Towle Deep Value Composite (DVC) experienced a sharp rally in September bringing year-to-date returns to what we see as a more respectable level. While this price improvement is promising, our portfolio holdings remain underappreciated in our view. As we enter the final stretch of 2019, the global trade war weighs heavily on investor sentiment and CEO confidence, holding back risk-taking and capital spending plans. These dynamics threaten the economic outlook and have caused manufacturing to weaken. Nevertheless, we still expect that the durability of the U.S. consumer, low inflation, low commodity prices, stable credit markets, supportive central bank policy, and advancing trade talks should sustain the economy's expansion. Considering this investment backdrop and the potential that investor confidence will improve from here, we believe the Towle portfolio is markedly undervalued.

Historical performance is presented below with periods greater than one year annualized.

<i>Periods ending</i> <i>9/30/19</i>	<i>Towle DVC</i> <i>(Gross of fees)</i>	<i>Towle DVC</i> <i>(Net of fees)</i>	<i>Russell 2000</i> <i>Value</i>	<i>S&P 500</i>
3 months	2.06	1.87	-0.57	1.70
9 months	12.21	11.62	12.82	20.55
1 year	-21.22	-21.80	-8.24	4.25
3 years	2.78	2.02	6.54	13.39
5 years	6.03	5.26	7.17	10.84
10 years	10.45	9.66	10.06	13.24
20 years	11.65	10.82	9.05	6.33
30 years	12.57	11.77	9.88	9.72
Inception (1/1/82)	15.23	14.41	11.57	11.62

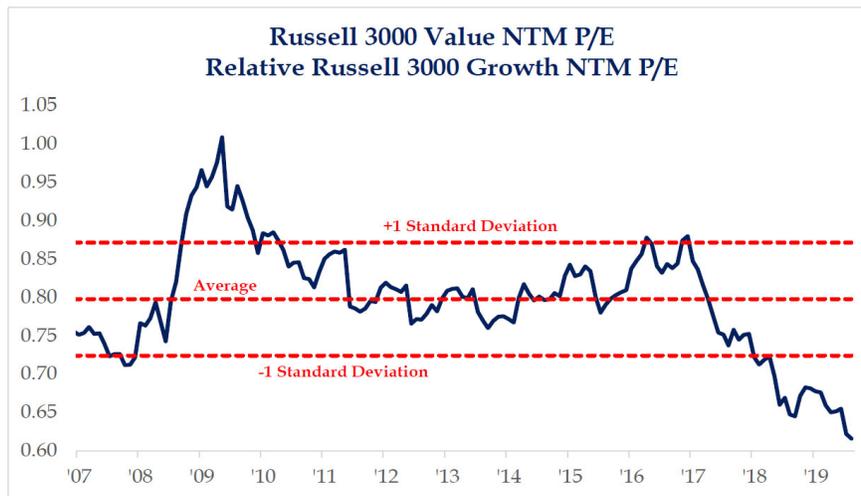
*Returns are preliminary and subject to change. Past performance is no guarantee of future outcome.
Please refer to the last page for additional disclosures.*

Historic Valuation Gap

In our second quarter investor letter dated April 11, 2019, we referenced the wide valuation gap between value and growth stocks. We alleged that such an extreme dispersion appeared unsustainable and might spell opportunity for long-term value investors.

On July 16, 2019, JPMorgan's Global Quantitative and Derivatives Strategy Group issued a research report with the subtitle, "*Largest divergence ever presents opportunity for Value and High Volatility stocks.*" In the report, Marko Kolanovic stated, "we think that the unprecedented divergence between various market segments offers a once in a decade opportunity to position for convergence. Currently, there is a record divergence between value/cyclical stocks on one side, and low volatility/defensive stocks on the other side." He went on to say, "The bubble of low volatility stocks vs value stocks is now more significant than any relative valuation bubble the equity market has experienced in modern history."

On October 1, 2019, Strategas Research Partners wrote, "we know not the time or the hour, but the undervaluation of Value stocks relative to Growth appears to be extreme – globally. Those believing in the concept of reversion to the mean might want to lean the other way." The following chart from Strategas illustrates the magnitude of the valuation gap by displaying the ratio of the next twelve month (NTM) P/E of U.S. value stocks divided by the NTM P/E of U.S. growth stocks.



Source: Strategas October 1, 2019. The Russell 3000 Index represents the U.S. broad stock market and is comprised of the 3000 largest U.S. publicly traded companies.

Wall Street’s rejection of the proposed WeWork IPO and shaky reception to the IPOs of Postmates and Peloton may be an early indication of a waning investor appetite for richly-valued, high-growth companies and a harbinger of better times ahead for value investors. Like Strategas, we know not when a sustainable rotation into value stocks will commence, but conditions appear ripe.

Portfolio Review

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

Road Ahead

Doubt and uncertainty seem to rule the current environment. Using Google Trends, August marked 5-year relative highs for the search terms “yield curve” and “recession”. Are these apparent fears justified? The Leading Economic Indicators remain at modestly positive levels. Housing starts in the U.S. were up 6.6% year-over-year in August. Inflation is low and stable, as are interest rates. Jim Paulsen of the Leuthold Group notes that productivity growth has recently exhibited a positive tone, and Ed Clissold of Ned Davis Research states, “There are initial signs that the economy is emerging from a deceleration.” (*Barron’s* 9/23/19) We believe that the level of negativity regarding the prospects for the U.S. economy is unwarranted.

We also note that steep market declines have historically followed periods of excess. Currently, we find few excesses on Main Street. The personal savings rate as measured by the St. Louis Federal Reserve was 8.1% in August versus a reading of 3.1% just prior to the Great Recession. Mortgage underwriting standards have tightened considerably with 59% of origination volumes registering a FICO score above 760 versus just 27% in the pre-crisis years. A similar pattern exists in auto loans. Prudence seems to be the norm on Main Street.

Will the earnings power of Towle portfolio companies remain underappreciated indefinitely? We believe that global growth should accelerate over time, supported by a positive outcome from the trade talks between the U.S. and China. Together, the two countries make up 34% of global economic activity, and the incentives seem ripe for a constructive conclusion. With a median 2020 P/E of only 7.5x for the Towle portfolio, an historic valuation divergence between growth and value, and surplus fear surrounding global economic growth, we remain optimistic about our portfolio. We are reminded of a favorite thought from Peter Lynch: “Remember, things are never clear until it’s too late.”

Towle & Co. fully recognizes that the past 18 months have been difficult. However, stock markets tend to operate in cycles, and we plan to overcome the current downturn by remaining fully invested in our undervalued holdings.

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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.