

# TOWLE & CO.

DEEP VALUE INVESTING

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To: Investors

Unappreciated! Prices dropped, and the steady financial progress demonstrated by Towle portfolio companies went unrecognized. While improving economic conditions persisted, U.S. equity markets reflected investor concerns regarding economic growth, political infighting, and exorbitant federal spending. Equity investors pulled back, awaiting government plans for fiscal improvement. As a result, investment capital sidestepped cyclical, small-cap stocks in favor of stable, low-return assets, making 2011 a very disappointing year for Towle Deep Value.

From our perspective, it is impractical to assume that Western governments will forever fail to act responsibly. Surely, agreements will be reached and plans will be undertaken to achieve appropriate fiscal stability. Nevertheless, no one can predict the financial adjustments that may occur prior to the adoption of appropriate federal fiscal policies in Europe and the U.S. In the interim, confidence in the capitalistic system suffers.

This public policy puzzlement hovers over the investment community; yet the private sector advances. Supported by population growth, high levels of productivity, and a low cost of capital, worldwide economic expansion continues. In due course, today's doom and gloom will lead to optimism and rebirth. So, in our view, opportunity is not diminished but is truly at hand, evidenced by the appealing three-year appreciation potential of 102% for the Towle portfolio.

2011's sub-par results are noted below:

Periods ending 12/31/11	Towle Composite (Gross of fees)	Towle Composite (Net of fees)	Russell 2000 Value	S&P 500 Total Return
3 months	9.11%	8.94%	15.97%	11.82%
1 year	-17.34	-17.97	-5.50	2.11
3 years	28.77	27.82	12.36	14.11
5 years	-0.75	-1.54	-1.87	-0.25
10 years	10.97	10.09	6.40	2.92
20 years	15.96	15.13	10.67	7.81
Inception (1982)	16.11	15.27	11.90	10.98

The year-end letter segments as follows: [A Tumultuous Year](#), [Masters Revisited](#), [Portfolio Review](#), and [Looking Long Term](#).

## **A Tumultuous Year**

Winter and early spring brought higher stock prices, but the strong headwinds of macro-economic discomfort emerged by May. Our second quarter letter dated July 12, 2011 summarized the events leading to a broad change in investor sentiment and behavior, "a slowing economic expansion, advancing inflation, unsettled U.S. fiscal policy, threat of sovereign default by Greece, supply disruption from world-wide natural disasters, and the scheduled withdrawal of Federal Reserve quantitative easing of June 30<sup>th</sup> spooked investors in the quarter." In response, stock prices headed down.

Commencing with the third quarter, the investment environment deteriorated even further as Standard & Poor's downgraded U.S. debt, and the European Union failed to execute a cohesive plan for sovereign debt reduction and fiscal austerity. Prospects for cooperation between our political parties disintegrated, also leaving the U.S. without a reasonable fiscal plan. Uncertainty and pessimism enveloped global equity markets for the balance of the year. The German DAX closed down 14.7%. China's Shanghai Composite fell 21.7%. Brazil's Bovespa dropped 18.1%.

Surprisingly, beyond the negative news and instability of the stock market, overall corporate profits remained satisfactory. More importantly, the U.S. economic recovery strengthened. Despite these positive trends, an unusual valuation dichotomy broadened between stocks and U.S. Treasuries. This valuation gap ended the year as follows:

Value Line Earnings Yield

7.14%

5 yr U.S. Treasury Yield

0.83%

Valuation Gap

6.31%

Other than the financial panic of late 2008 to early 2009, this gap approached an historic high, suggesting a noticeably undervalued stock market based on year-end prices and 2012 earnings projections.

During the second and third quarter sell-offs, the Towle portfolio declined disproportionately as investors moved away from smaller, cyclical investments in favor of fixed income securities and large, dividend-paying companies. Provided below are the portfolio’s results by quarter, illustrating the rapid mid-year shift in perception to the downside:

	<u>1<sup>st</sup> Qtr</u>	<u>2<sup>nd</sup> Qtr</u>	<u>3<sup>rd</sup> Qtr</u>	<u>4<sup>th</sup> Qtr</u>
Towle Composite (net of fees) (%)	7.23	(6.78)	(24.67)	8.94
Russell 2000 Value (%)	6.60	(2.65)	(21.47)	15.97
S & P 500 (%)	5.92	0.10	(13.87)	11.82

Throughout 2011, ACME, our investment environment monitor, failed to flash meaningful, negative signals. Within the four categories of measurement, many indicators hit the normal level but signs of excess in valuation, interest rates, and economic activity were simply absent. In view of the advancing private sector underpinnings, we elected to persevere through the difficult stock market downturn.

In conclusion, equity markets ended the year transfixed by political uncertainty. Hemmed-in by slow economic growth and unresolved federal deficiencies, investors held back, reluctant to add capital to a highly volatile investment backdrop. Consumer confidence and expectations for economic growth are restrained entering the New Year.

**Masters Revisited**

The words and works of master investment practitioners Warren Buffett, Benjamin Graham, and Sir John Templeton are foundational to the underlying investment philosophy at Towle & Co. How would these investment pioneers reflect on today’s contradictory investment environment of political dysfunction, record federal deficits, high corporate profit margins, historically low interest rates, and investor anxiety?

**Warren Buffett:** “At Berkshire, we focus almost exclusively on the valuations of individual companies, looking only to a very limited extent at the valuation of the overall market. Even then, valuing the market has nothing to do with where it’s going to go next week or the next month or next year, a line of thought we never get into. The fact is that markets behave in a way, sometimes for a very long stretch, that are not linked to value. Sooner or later, though, value counts.” (*Fortune*, 1999)

**Benjamin Graham:** “The disciplined, rational investor neither follows popular choice nor plays market swings. Rather he searches for stocks selling at a price below their intrinsic value and waits for the market to recognize and correct its errors.” (*The Intelligent Investor*, Harper & Row 1973)

**Sir John Templeton:** “One of the reasons our performance is said to be the best investment record in the world on a twenty to twenty-five-year basis is that we’ve always tried to look-ahead--and the long-range view requires patience.” (*The Templeton Touch*, Doubleday 1983)

The masters strongly suggest that a patient, low-priced approach to stock selection supports investment success.

In James P. O’Shaughnessy’s recently released fourth addition of *What Works on Wall Street*, he states the following: “To get the most out of their equity investment, investors should let good strategies work. Don’t second guess them. Don’t try to outsmart them. Don’t abandon them because they’re experiencing a rough patch.” (*Investment News*, December 5, 2011) Well-recognized in the investment community, O’Shaughnessy supports the three great investment pioneers with his more contemporary message of perseverance.

The Towle strategy is steadfast, emphasizing low valuation and patience. Please note below the year-end valuation comparison (not including financials) between the Towle portfolio and the S&P 500.

<u>Median</u>	<u>Towle</u>	<u>S&amp;P 500</u>
2012 Consensus P/E	7.7x	13.5x
Price-to-book	0.8	2.5
Price-to-Sales	0.2	1.4
Enterprise Value-to-EBITDA	5.1	8.4

Source: Zack's; Thomson Financial

Now, like the masters, we wait.

### **Portfolio Review**

As mentioned, the year commenced with firm, stable equity pricing. Analysts projected modest earnings growth. Forecasted P/E ratios were in-line with historical measurements, not excessive. As it turned out, earnings for 2011 generally met these expectations. Book values expanded. However, portfolio prices declined, failing to reflect the financial progress of 2011.

**This section has been edited from its original format to exclude specific securities transactions.**

### **Looking Long Term**

The Lost Decade for equities now adds up to thirteen years. Ending 1998 at 1229.2, this year's close for the S&P 500 Stock Index of 1257.6 confirms the lack of investment progress. The economic and financial gyrations since 1998 have greatly impaired the optimism and risk profile of many investors. The technology investment bubble of 1998-2000, a form of investment insanity, was followed eight years later by the worst recession and financial panic in 80 years. Amid these two periods, a generational advance in construction and single family home prices collapsed, leaving millions of homeowners with no equity and burdensome mortgage debt. While deleveraging in the private sector is meaningfully underway, federal U.S. debt and spending are out-of-balance, excessive, and risking the financial viability of the U.S. government. Will the headwinds ever lift?

No surprise, our view is to the bright side. In aggregate, the increasing demand for global goods and services is staggering. Since the S&P 500 first crossed 1200 in 1998, world population has expanded by roughly 1 billion or 16.6%. According to the World Bank, roughly 50 million people attain middle class economic status each and every year. On a per capita basis, war and violence are at an all time low. The costly war in Iraq is over. The Arab Spring foretells the advent of democracy and freedom.

Within the U.S., a case can be made for better days ahead.

- Households continue to deleverage, following excessive borrowings from 1997 to 2007. (*Wall Street Journal*, October 20, 2011) The household debt-to-service ratio has greatly improved, returning to 1994 levels. Employment is expanding. Modest economic growth is occurring. Corporations possess solid profitability and sturdy financial positions. The overall economic trend is positive and persistently upward since mid-2009.
- Structural, economic change is underway. A modest renaissance in manufacturing is taking hold as the U.S. gains ground on worldwide cost competitiveness. A movement toward energy self-sufficiency is evolving as natural gas and alternative fuels are domestically developed.
- Housing and consumption will pick up as excessive debt and overbuilding are worked off. On a per capita basis, housing starts and light vehicle sales will lift from unsustainable, multi-decade lows. And population growth continues, roughly 3.0 million annually.
- Deficit reduction progress will be made. It has happened before. The Canadian government's rebalancing and restructuring story of the 1990's is well documented. More recently, Ireland, battered by a severe real estate bust and the nationalization of most banks, has set forth a plan. "Irish politicians across the political spectrum are on board with a plan... Austerity in Ireland has been greeted with an air of resignation rather than protests and strikes..." (*Barron's* November 2011) Political compromises must be found. There is no other choice.

The Towle portfolio continues to exhibit noteworthy characteristics of undervaluation. Consensus earnings estimates for 2012 show an extremely low, median P/E of 7.7x. A return to 52-week highs would advance portfolio valuation by 73%. Companies in the portfolio exhibit financial strength and leading market positions. As a result, we are not willing to accept today's values as a reflection of long-term portfolio worth. Periods of exceptional reward are always preceded by

times of irrationality and uncertainty. Looking long-term, the markets will adjust upward, fully appreciating the attractiveness of the Towle portfolio.

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For 2011, realized gains exceeded losses. As mentioned in previous correspondence, this condition takes advantage of the low 15% capital gains/tax rates which is likely to increase on January 1, 2013. Year-end reports are enclosed, including a final 2011 capital gains/loss report for separately managed taxable accounts. For limited partners in Towle Capital Partners, L.P. and Towle Capital Partners II, L.P., K-1's will be distributed in mid-March.

We remain open for capital additions to include our newly launched mutual fund. To learn more about the mutual fund, please call our office and ask for Joe Bradley. In the unsettled investment period of today, we are especially grateful for your support, patience, and commitment. Your inquiries are welcomed, as always.

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#### **DISCLOSURES**

Past performance is no guarantee of future outcome. Results reported reflect the deduction of trading expenses and in some cases custodial fees and other expenses. Results are calculated using a time-weighted total-rate-of-return method and are expressed in U.S. dollars. Results are presented gross and net of management fees and include the reinvestment of all income. Net of fee performance was calculated using actual management fees. 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 performance. Compared to the Russell 2000 Value Index, Towle & Co. invests in companies with lower multiples to book value, sales, earnings, and cash flow. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.

We urge investors to carefully compare the enclosed appraisal reports from Towle & Co. with your account statement received directly from the custodian, in the case of separate accounts, or from the third-party administrator, in the case of the two limited partnerships. Rule 204-3 under the Investment Advisers Act of 1940, commonly referred to as the "brochure rule," requires every SEC-registered investment adviser **to offer or deliver** a brochure to existing clients, on an annual basis, without charge. If you would like to receive a brochure please contact us at (314) 822-0204, send an email to [info@towleco.com](mailto:info@towleco.com), or visit [www.towleco.com](http://www.towleco.com).