TOWLE & CO.

October 23, 2024

Wacko! Just six months ago at the end of Q1, the Towle Value Composite (TVC), net of fees, was outperforming the Russell 2000 Value Index (R2KV) across the 1-year, 3-year, 5-year, 10-year, 20-year, 30-year, and since inception periods. However, in Q2 we were down 11% while the R2KV was down 4%, and in Q3 we fell another 1% while the R2KV gained 10%. TVC is now behind on the 1-year, 3-year, 5-year, and 10-year timeframes. **Like you, we are feeling the whiplash.**

In recent performance terms, both TVC and our low Enterprise Value to Sales (EV/S) sandbox are stretched further below the R2KV than almost any other time *in over six decades*. And it has been abrupt. Across just June, July, and August, TVC was down 8% while the R2KV was up 8%. **The good news is that this underperformance is in the rearview, and we see a generational opportunity for our space not unlike the small-cap value bull markets of the late 1970s or early 2000s.**

This letter follows a Q&A format to pay homage to our January 2000 letter, written during a similar period when we trailed both the R2KV and the technology-driven markets of the time. We have also sprinkled in contents from prior letters to highlight that the current environment is not unprecedented. For example, this quarter's exclamatory opener comes from one of our descriptions of the market in our April 1999 letter. Today, with multiple big tech companies valued at more than 10% of U.S. GDP *each* and staring down our YTD performance relative to the R2KV, "wacko" seems apt.

By Q3 of 2000, our trailing 1-year return was -9% while the R2KV was up 15%. A presidential election was on the horizon, technology stocks had performed well and were in vogue, and some Towle clients left to chase technology stocks at what turned out to be the worst time.

Some of you will remember, however, that TVC not only caught up to the R2KV and S&P 500 in short order, but further outperformed for several years thereafter. **From 12/31/2000 through 12/31/2006 TVC appreciated 296% while the R2KV and the S&P 500 were up only 133% and 19%, respectively.[1] We believe the similarities between today and the early 2000s period are many and strong.** All Towle investment team members have added personal capital, as we believe today's extreme underappreciation for Towle's economically-essential companies is entirely unsustainable.

Towle Value Composite returns are highlighted below with periods greater than one year annualized:

Periods ending 9/30/24	*TVC (Gross of fees)*	*TVC (Net of fees)*	*Russell 2000 Value*	*S&P 500*
3 months	-0.93%	-1.18%	10.15%	5.89%
YTD	-9.07	-9.77	9.22	22.08
1 year	7.34	6.24	25.88	36.35
3 years	3.47	2.44	3.77	11.91
5 years	10.09	9.00	9.29	15.98
10 years	8.04	6.97	8.22	13.38
20 years	9.01	7.93	7.74	10.71
30 Years	11.68	10.57	9.60	10.84
Inception (1/1/82)	14.62	13.48	11.30	12.12

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

[1] *Returns are cumulative and TVC returns are reported net of fees.*

Q&A

Below are answers to common client questions from the past few months. If you need further clarification or have additional questions, please contact us at (303) 731-2494 or info@towleco.com.

1. **Why did Towle underperform so drastically in the last two quarters?**

A single macro tradeoff seems to explain the weak performance of our small-cap stocks relative to the R2KV: enthusiasm for *interest-rate-sensitive* stocks has come at the expense of well-capitalized, cyclical stocks that don't need rate cuts to bolster equity values.

When Federal Reserve Chairman Jerome Powell intimated in July that a 50 basis point cut in federal funds rates would be forthcoming, interest-rate-sensitive stocks took off. Banks, insurers, REITs, companies carrying substantial debts, and a collection of money-losers (notably biotechnology companies) appreciated quickly, as did more speculative microcap issues and stocks with high levels of short interest.

Over five consecutive trading days in mid-July, the R2KV rose over 12%. We did not. The Towle investment process purposefully steers clear of the types of companies that happened to lead the R2KV rally. Using our low EV/S criteria along with risk management filters, we screen out companies with excessive debt loads, poor liquidity, and high short interest, focusing instead on companies that have demonstrated an ability to produce substantial profits. **Ours is a pure value approach, and the same investment process that helped us outperform the R2KV in 2022 and 2023 (-2.6% vs -14.5% in 2022, +19.1% vs +14.6% in 2023) led us to miss out on the somewhat speculative, rate-driven rally in July.**

On the other side of the tradeoff, the market remains concerned about the Federal Reserve's ability to orchestrate an economic "soft landing." With holdings that are sensitive to the health of the economy, the Towle portfolio generally underperforms when recession fears take hold. **However, given recent economic data showcasing healthy GDP growth, reasonable inflation, healthy levels of unemployment and hiring, strong retail sales, and plentiful liquidity, our portfolio appears underpriced against all but the deepest of recessionary conditions.**

Predictably, our entire low EV/S universe has also drastically underperformed. Close study of the history of low EV/S stocks reveals several periods during which our universe appears to miss out relative to the R2KV to the same degree as today. Of note, those are concentrated in the early 1970s (Nifty Fifty), late 1990s (Dot-Com), and 2008 (GFC). This has happened before, both to the Towle portfolio and to our cheap EV/S universe.

Measured on a quarterly frequency, below we show TVC's 10 lowest trailing 9-month relative return spreads plus our position today. Trailing relative returns are on the left, 3-year forward relative returns are on the right. **As always, time will tell, but we feel very optimistic about where the pendulum swings from here:**

As of Date	*9-Month Trailing Performance*			*3-Year Forward Cumulative Performance*		
	TVC, Net	R2KV	Spread	TVC, Net	R2KV	Spread
12/31/08	-51%	-24%	-27%	107%	42%	65%
06/30/00	-14%	7%	-21%	76%	37%	40%
09/30/24	***-10%***	***9%***	***-19%***	***?***	***?***	***?***
06/30/91	15%	32%	-17%	176%	69%	106%
09/30/00	-3%	14%	-17%	82%	37%	45%
03/31/00	-19%	-3%	-16%	47%	13%	33%
06/30/19	-23%	-8%	-16%	36%	20%	17%
06/30/12	10%	26%	-15%	93%	54%	39%
12/31/95	6%	21%	-15%	55%	50%	5%
06/30/90	-21%	-7%	-14%	97%	60%	37%
12/31/18	-25%	-11%	-14%	64%	64%	-1%
Average	-12%	5%	-17%	83%	45%	39%

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2. **<u>Is Towle & Co.'s value strategy now obsolete in view of worldwide technological changes?</u>**

We remain confident in the efficacy of our value strategy over the long run. After all, it takes much longer than two quarters to conclude that any stock selection process is good, bad, or useless. And given the recent underperformance of the entire low EV/S universe, we have been facing extreme style headwinds. **These two difficult quarters reflect the market segment in which we operate, not flaws in our strategy.**

In our January 2000 letter we posed the exact same question. Our answer then: "Nope. Financial markets normally transition from undervalued to overvalued and on occasion move to extremes… Conditions change. Sentiments change. Prices change. Any well executed, value-based investment approach will produce acceptable returns as long as economic progress is at hand." Today, we could not agree more.

Fundamentally, the Towle portfolio is operating beautifully. In Q2, 84% of our portfolio companies met or beat earnings expectations, and 88% of our portfolio companies generated positive earnings on a trailing twelve-month basis. **We continue to buy essential businesses with satisfactory and/or improving results that have generally exceeded unduly pessimistic expectations.**

3. **<u>Why invest in small-cap stocks? Isn't the small-cap premium gone?</u>**

Advantageous mispricings of securities are more frequent in small caps by virtue of capital scarcity. **It is easier to find bargains when hunting alone than when bidding against many others.** This is why we invest in small-cap stocks.

Slow moving market tides ebb and flow over long cycles, and large caps have outperformed for well over a decade now. This is acutely evident in an increasingly concentrated, tech-dominated market. But tides change. Per Furey Research: **"small-cap trailing 10-year relative return versus large-cap is near 80-year lows. These lows have been reached multiple times in the past and each time it looked as if small-caps had been left for dead, only for them to recover strongly in forward years."**

The heavy concentration at the top end of the large-cap space (Apple, NVIDIA, Microsoft, Alphabet, Amazon, Meta) has amplified today's performance imbalance. Historically, extreme concentration tends to come before a shift in market leadership. At some juncture, capital will likely broaden across under-allocated areas of the market, and the sheer magnitude of this shift could be dramatic. **For reference, just a 5% reallocation of the $15T in market value from those six stocks above would equate to 39% of the $2T in total market value of the entire Russell 2000 Value!** Just BlackRock's 7% of Apple's $3.5T market cap could acquire every company in our portfolio. Perhaps that helps explain why Warren Buffet's Berkshire Hathaway recently cut its Apple stake in half.

We believe a recovery from today's extraordinary large-cap outperformance is a matter of when, not if. And we feel our portfolio is well-positioned to benefit when the market reallocates. As we wrote in 2000: "Our stocks are compelling investments – strong market positions, debt levels below equity, good cash flows, solid forward earnings expectations, forward P/Es below 10x, experienced management teams, and stock prices noticeably below two-year highs." The same holds true for today's Towle portfolio, setting the stage for a potential sea change.

4. **<u>Has the market fundamentally changed?</u>**

Yes and no.

Yes, the *vehicles and transactional simplicity* enabling public equity investing have changed. Passive investing via index ETFs and index mutual funds, high-frequency trading technologies, round-the-clock global access, and nearly costless trading are all relatively new market phenomena. Of course, faster investing is not synonymous with better investing.

No, the *laws of human nature, economics, and capital scarcity* are the same as always. The basic human preference for predictability in a world full of surprises continues to create dislocations in share prices. The tendency of humans to feel safety in herds continues to foster crowded trades in some parts of the market and abandon stocks in others. In the long run, valuation does matter. **And since equities are priced on expectations about the future, we continue to seek opportunities to invest in underdogs with sufficiently low expectations.** In these ways, the market behaves as it always has.

5. **Under what conditions should investors choose active management over passive management, and why active management specifically in small-cap value?**

Passive investing as a strategy choice has its merits, particularly in large caps where analyst coverage is so prevalent that the likelihood of unearthing bargains is very low. If an investor wants broad market exposure at low cost, the logic of the past 10-20 years says to do that in a low-cost mutual fund or ETF. We tend to agree with at least one caveat. **Many large-cap passive vehicles today fail to provide prudent diversification.** In market cap-weighted S&P 500 funds, the largest six companies account for nearly 30% of total assets. We don't think that represents the broad, diversified exposure most investors are looking for in passive vehicles. Piper Sandler's chief investment strategist agrees. As described in Barron's, his team has concluded that, "the large influence of these few stocks means the S&P 500 no longer represents 'the market.'"[2]

Further down the market cap spectrum, we think active management becomes a no-brainer. For a start, some passive options in small caps fail to deliver on expectations. **Over 42%[3] of companies in the Russell 2000 Value Index lose money, including zombies and start-ups that belong in a growth index.** While passive indexing in small-cap value may seem like a simple solution, we find it unadvisable. In contrast, active value-seekers like us have the potential to add significant value over time.

6. **What is the impact of Artificial Intelligence (AI) on our business and portfolio companies?**

Two and a half decades ago we were asked how our holdings might benefit from the commercialization of the internet. Today's topic du jour is the potential commercialization of artificial intelligence. **As of this writing, companies that are developing AI technologies are richly priced and not in the low EV/S universe, so AI has not directly entered the Towle portfolio.**

However, many of our holdings use AI to optimize their distribution networks, determine pricing, and schedule personnel in industries like automobile dealers, electronic component distributors, grocery wholesalers, airlines, and auto parts manufacturers. Time will tell how much of the efficiency derived from AI will impact portfolio company earnings.

Internally, we have also asked ChatGPT to help us draft these letters, perform basic equity research, and answer one-off questions about markets and companies. While we find it a useful tool for drafting, its propensity to make up "facts" and present them with confidence is astounding.

7. **What impact will the presidential election have on performance?**

Election results and subsequent equity returns are impossible to predict with certainty. The historic tendency for our cyclical portfolio has been to absorb a disproportionate amount of fear and uncertainty which has then alleviated in the months following the election. **Stated differently, we tend to underperform into an election and outperform once it's over, regardless of the specific election outcome.**

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[2] *Barron's, July 8, 2024*
[3] *Strategas Securities, 10/4/2024*

Quarterly Portfolio Review

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

Looking Ahead

"My point is that it's easy to make lists of problems. Of everything that could go wrong or get worse. I could do it with my eyes closed, and so could you. It's much harder to have the imagination and the courage to talk openly about what might go right. What might improve…Paradoxically, these types of improvements come along all the time. Given the long-term trend toward progress…we ought to be more comfortable discussing the positives than we are."
Josh Brown, You Weren't Supposed to See That, 2024

If there is one trait demanded of value investors, it is the ability to see the glass as half full. Stocks in our cheap sandbox face negative sentiment by definition, and it takes a keen, patient eye to see the potential for future good. In that light, we want to use this section for one more Q&A.

8. **What could go right?**

   Investing history demonstrates that trailing and forward performance, in both absolute and relative terms, tend to counterbalance. **High forward returns are typically available when trailing returns are at their lowest levels.** Towle's poor trailing relative returns are yesterday's bad news. Paradoxically, that likely means good news for tomorrow and beyond.

   On the one hand, we all know what could go wrong. The economy could eventually go into recession, conflict in the Middle East could spiral, inflation in the U.S. could turn back up, and a host of other fears could materialize. **In our stocks, we think those fears are overrepresented in today's prices.**

   We believe the stage is set for a sustained rally in low EV/S small-cap value stocks, driven by:

   - **Global liquidity**: In recent months, central banks including the U.S. Federal Reserve, the Bank of England, the European Central Bank, the Bank of Japan, and the People's Bank of China have adopted or maintained loosening measures. **This global easing cycle should be a powerful force for public equities, and particularly for equities that are economically sensitive and cheap.**

   - **Declining interest rates**: Rate declines have created a short-term performance differential between our portfolio and the R2KV as explained above, but the longer-term impact should be positive for the economy and therefore positive for our cyclical portfolio. Broad-based interest rate declines 1) stimulate consumer demand in large-ticket goods like cars, homes, and appliances, 2) reduce the cost of floating rate corporate debt, more common in the small-cap space, and 3) stimulate commercial demand for property, plant, and equipment – sweet spots for the hard-asset businesses in the Towle portfolio. Housing itself represents nearly 20% of GDP, and 30-year fixed mortgage rates are down nearly 200bps and likely headed lower. For a country clamoring for more housing, lower mortgage rates should give a meaningful boost to the economy.

   - **Revenge of the old economy**: Market veteran Jeff Currie leads Carlyle's infrastructure and energy efforts, and had the following to say in a recent interview (our emphasis in bold): "**It happened in the 1960s… It was the revenge of the old economy. The country hadn't kept investing in all the nonfinancial physical stuff.** Exxon was a terrible stock during that time period. A demand shock occurred with President Lyndon Johnson's Great Society initiative, and old-economy companies and stocks were off to the races. There is a close analogy to today… **It happened in the 1990s, too. We had low and stable inflation and low interest rates, and the market chased long-duration stocks. It was the dot-com era. And then, again, the old-economy stocks came back to life.** The demand shock that time was the rise of China."[4] Every dollar

[4] *Barron's, August 15, 2024*

invested in the Magnificent 7 cannot also be invested in the physical infrastructure necessary to support our economy. We are bullish on old-economy stocks.

- **Buybacks**: Large stock buyback programs highlight strong corporate free cash flow and internal conviction in unrecognized market value. They are also among the most tax-efficient ways for companies to return profits to shareholders. Despite garnering all the headlines, buyback programs at the largest companies pale in comparison to the Towle portfolio when scaled for market cap.

We believe the odds are stacked in our favor with this supportive backdrop. **Underperformance for our low EV/S specialization has reached an unsustainable level, and the stage may be set for a sustained period of outperformance versus both large-caps and the broader small-cap value universe.**

Our dear founder, Woody Towle, was a perpetual optimist. He knew how to see the good. And if he were with us today, he would undoubtedly echo the patience and optimism from our July 2000 letter: **"The investor stampede to growth and super cap stocks has left our sector literally abandoned by the professional investment community… We wait patiently knowing that the "good works" exhibited by our companies are not to be ignored but properly recognized."**

Resolute in our conviction, the Towle team has added personal capital. We know low EV/S investing works well over the long run. We've been doing it for over 4 decades, and the data tell us that low EV/S stocks worked long before Woody opened our doors in 1981. We are confident that the current lull will resolve itself and that low EV/S investing continues to hold significant potential for generating excess returns in the years ahead.

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