TOWLE & CO.

Deep Value Investing

January 19, 2024

Goldilocks? Slowing inflation, a less hawkish Fed, and rising optimism about a soft landing helped the Towle Deep Value Composite to an 18% net return in Q4, finishing the year up 19% net of fees.

What a year it has been! As we recap below, 2023 brought a mix of surprises. One positive surprise was Towle Deep Value's significant outperformance in December compared to the richly valued technology sector. Could this be the start of the long-awaited Great Rotation? Impossible to know. Regardless, the Towle team is eagerly invested alongside you, our treasured clients, and looking forward to a future that holds promise for our undervalued portfolio.

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

Periods ending 12/31/23	*Towle DVC (Gross of fees)*	*Towle DVC (Net of fees)*	*Russell 2000 Value*	*S&P 500*
3 months	18.04%	17.74%	15.26%	11.69%
1 year	20.30	19.12	14.65	26.29
3 years	14.63	13.50	7.94	10.00
5 years	14.82	13.69	10.00	15.69
10 years	8.30	7.22	6.76	12.03
20 years	10.48	9.38	7.68	9.69
30 Years	12.43	11.31	9.33	10.15
Inception (1/1/82)	15.16	14.02	11.28	11.81

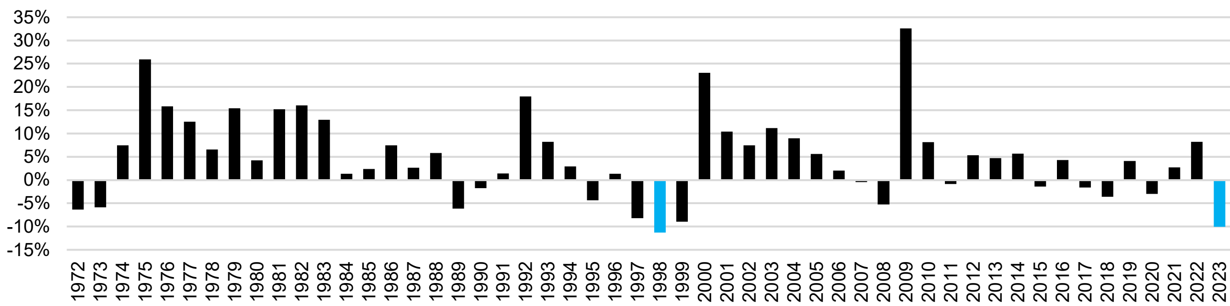
Returns are preliminary and subject to change. Past performance is no guarantee of future outcome. Please refer to the last page for additional disclosures.

2023 in Review

According to Harvard economist John Kenneth Galbraith, "There are two kinds of forecasters: those who don't know, and those who don't know they don't know." We agree! After all, who could've predicted these 2023 surprises?

- **Bank Failures**: Mismanaged interest rate risk led to Silicon Valley Bank, Signature Bank, First Republic, and Credit Suisse failures.
- **Crypto Collapse**: FTX, a major digital currency exchange, went bankrupt in spectacular (and criminal) fashion.
- **Recession Odds:** Despite bearish predictions, including a 100% probability from a Bloomberg model, the U.S. economy avoided a recession in 2023.
- **Homebuilder Resilience:** Despite a multi-decade low in housing affordability, homebuilders emerged as top performing stocks in 2023.
- **Tech Stock Surge:** AI-driven enthusiasm propelled select tech stocks to unprecedented levels, defying the highest interest rates in nearly 15 years.
- **Extreme Concentration**: Led by the "Magnificent 7," index concentration reached 50-year highs.
- **NFL Victories:** Perhaps Towle's positioning in steel and automotive stocks helped the Cleveland Browns and Detroit Lions both clinch playoff spots, marking their first joint postseason appearance since 1994, 30 years ago.
- **S&P 500 Disparity:** As shown in the chart below, the market cap weighted S&P 500 outperformed the equally weighted S&P 500 by a spread not seen since the dot-com bubble and only seen twice in over 50 years:

Equal-Weight S&P 500 Minus Cap-Weight S&P 500



Source: Y Charts, Towle & Co.

With inflation easing, expectations for 2024 have already swung squarely to interest rate cuts. How many times will the Fed cut in 2024? Nobody knows. Thankfully, Towle & Co. is not in the business of making unpredictable economic or market forecasts. Instead, we place our focus on something we *can* know: valuation.

Owing to our valuation-first investment process, our portfolio started 2023 overweighted to consumer discretionary (40% vs. 10% for the Russell 2000 Value), materials (9% vs. 5% for the R2000V), and energy (19% vs. 6% for the R2000V). All three areas performed admirably.

Are these outcomes predictable? Certainly not. We know we don't know. Instead, we rely on conviction in our systematic process, finding low valuations that signal low expectations. Unfettered by prescriptive forecasts, positive performance should unfold as low expectations are defied.

Predictions are difficult. Thankfully, valuation exists.

Quarterly Review

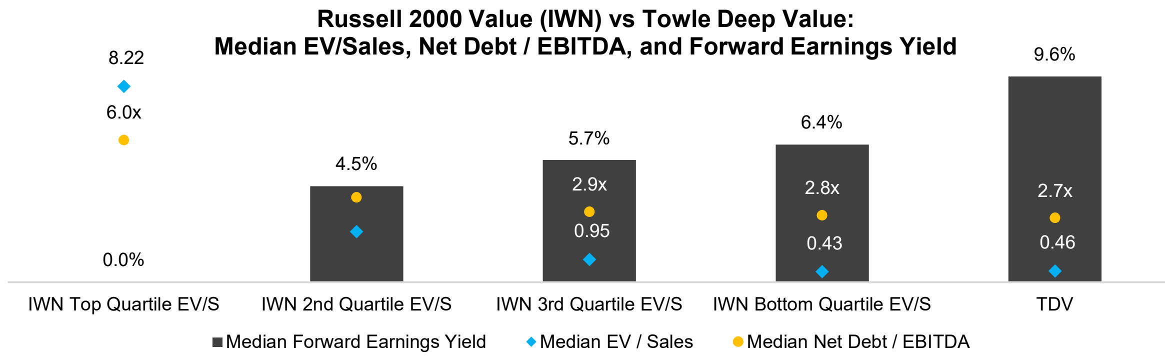
This section has been removed for compliance reasons to exclude discussing specific securities transactions.

Looking Ahead

In a diverse investment world full of different styles and approaches, the Towle team is exceptionally grateful for our proven process that allows us to "know what we know." The future is uncertain. Valuation, on the other hand, is certain. And as our track record demonstrates, it is valuation that enables us to capitalize on uncertainty at prices low enough to skew the distribution of future outcomes in our favor. As darkness gives way to light, investor sentiment improves, and share prices move higher. This is the natural flow for the steady deep value investor.

We've witnessed this flow over the past several years. The fog of higher interest rates and muddled trade flows in 2022 allowed a cheap Towle Deep Value portfolio to outperform in a down market (down 2% vs. the R2000V down 14%). In 2023, the fog of a "likely" recession cleared, and our undervalued portfolio managed to outperform in an up market (up 20% vs. the R2000V up 15%). A cheap, contrarian portfolio can add value in multiple environments! Key to success, however, is buying at the point of maximum uncertainty to increase the odds of sentiment improvement. Valuation does the trick.

Despite the good year in 2023, we think our deep value portfolio is still one of the most attractive places to invest – even compared to our benchmark. Splitting the Russell 2000 Value holdings into quartiles based on enterprise value to sales, our portfolio showcases a higher earnings yield and lower debt than even the cheapest quartile for the Russell 2000 Value:



Source: S&P Capital IQ, Towle & Co.

Passively buying the index, such as through an ETF, has become a popular decision. But if investors want a true value allocation, they ought to look deeper. More than one in four Russell 2000 Value holdings is forecast to generate negative earnings in the next 12 months, while the Towle portfolio only has two out of 37. Time will tell, but we steadfastly believe our active deep value approach is superior to the passive method. What's more, passive flows are bound to create valuation risk – a risk evident not just in today's S&P 500, but even in the Russell 2000 Value.

Christopher D. Towle
James M. Shields, CFA
Peter J. Lewis, CFA
Wesley R. Tibbetts, CFA
G. Lukas Barthelmess, CFA

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