TOWLE & CO.

July 19, 2024

Resolute! Living through this surreal era of mega-cap tech dominance, it's tempting to believe the small-cap value premium is dead. However, history reveals that investor behavior naturally creates cycles, stemming from our propensity to overreact and then overcompensate. This emotional tendency ensures that cycles persist, even if their nature and duration exceed expectations.

The current cycle stands out as extraordinarily peculiar. Despite persistently low consumer confidence and the Fed's aggressive tightening, this bull market continues, driven almost exclusively by a handful of highly valued, mega-cap technology companies. Notably, the S&P 500 set 31 new all-time highs year-to-date through June 30, while most stocks, particularly small-cap value, lagged. Stock market technicians are perplexed. We believe this narrow market leadership signals increasing risk for most investors, underscoring the need for discipline, rationality, and a diversified portfolio – qualities that distinguish successful long-term investors.

Given the cyclical nature of returns, we view sustained large-cap growth outperformance over small-cap value as increasingly suspect. On July 11, small caps outperformed large caps by 4.5% following a favorable CPI report. It marked the third largest one-day move in over three decades, reminiscent of pivots in 2000, 2008, and 2020 that signaled sustained shifts in market leadership. While it's too soon to declare victory, our disciplined investment process deploys capital in the most neglected areas of the market, potentially yielding very attractive returns should the small-cap rally endure.

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

Periods ending 6/30/24	*Towle DVC (Gross of fees)*	*Towle DVC (Net of fees)*	*Russell 2000 Value*	*S&P 500*
3 months	-10.83%	-11.06%	-3.64%	4.28%
1 year	8.67	7.58	10.90	24.56
3 years	2.73	1.71	-0.53	10.01
5 years	10.75	9.65	7.07	15.05
10 years	6.88	5.82	6.23	12.86
20 years	9.25	8.17	7.23	10.29
30 Years	11.80	10.69	9.41	10.80
Inception (1/1/82)	14.74	13.60	11.12	12.04

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

Investment Environment

"History doesn't repeat itself, but it often rhymes." Mark Twain (supposedly)

"In 1929, the glamour stock was an electronic concern – RCA – although the word electronics had not been invented. Investors felt there must be magic in any industrial process they did not understand, and they still feel that way."
John Kenneth Galbraith, 1970

For public market investors with the goal of outperforming, it is critical to skate to where the puck is going. At times this can be a difficult task. But today, with mega-cap technology prices and valuations stretched past statistically significant levels, we think it is more straightforward. Let's start with where the puck is now.

The following chart from Bank of America shows a relative price comparison of technology stocks and the S&P 500. **At the very least, this chart is a warning signal for anyone with substantial exposure to technology stocks, including the market-cap weighted S&P 500 itself.** The only historic analogs in a century are the Nifty Fifty and the Dot-Com Bubble:

Chart 3: Tech at all-time highs vs S&P 500

Tech vs S&P 500 (price relative)

Source: BofA Global Investment Strategy, Bloomberg

Market history is full of companies and stocks that follow the same general path: first mover or innovator in a new tech-enabled field, with incredible growth and profitability, leading to dominant market share and equity overvaluation, followed by an equity correction of 50% or more, finally struggling for decades to reclaim prior highs. That description fits Cisco, Intel, Nokia, and IBM at the turn of the millennium; IBM, Kodak, Xerox, and Polaroid in the late 1960s; and even Radio Corporation of America during its ascent in the 1920s. Likewise, today's Magnificent Seven rhyme with the first parts of that path. All have posted impressive financial results, all have dominant market shares, and valuations look very stretched.

So, are today's mega-cap tech companies different enough from those of the late 1960s and 1990s to escape the fates of those historical groups? It's hard to be sure, but a growing chorus is beginning to say "no." The lead article in Barron's from July 8th was blatantly titled "Are the Magnificent Seven unique? Hardly. Prepare for a fall."[1] The Economist ran a piece in May titled "Big tech's capex splurge may be irrationally exuberant." Even Sequoia Capital, a venture capital firm investing at tech's cutting edge, released a note titled "AI's $600B Question," with the subtitle "The AI bubble is reaching a tipping point. Navigating what comes next will be essential," in which the author writes, "If my forecast comes to bear, it will cause harm primarily to investors." **The sentiment tide may be turning, and our small-cap value portfolio is ready for appreciation.**

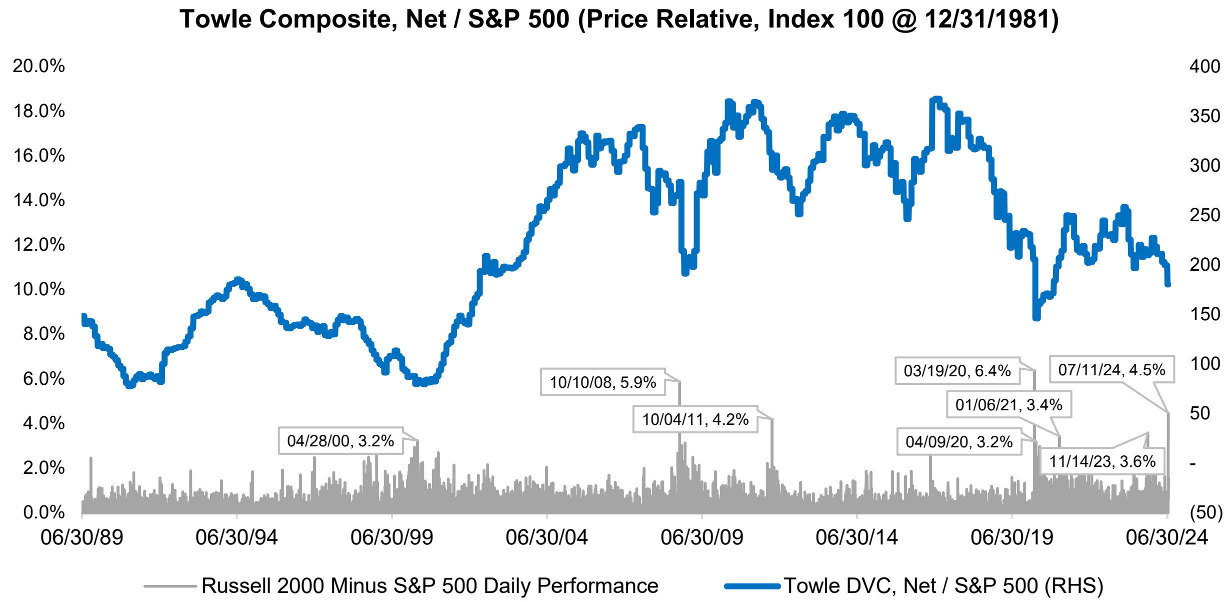
One difference this time around has been the influence of passive investors. In the Barron's article previously mentioned, the author points out (our emphasis underlined), "The risk, then, is that the biggest stocks in cap-weighted indexes such as the S&P 500 get bid up, both because of bullishness about future prospects and due to the mechanics of indexation. <u>Passive index investors necessarily funnel the most money to the most overvalued stocks</u>." **Perhaps the difference this time is that markets have pushed to even further extremes.** Like the absence of earthquakes increases the likelihood of one occurring as pressure builds between tectonic plates, drawdown risk at the top intensifies as valuations and the concentration in these few mega-caps climb.

We've been writing about these market dynamics for many grueling quarters, willingly admitting that we don't know when the cycle will turn. But we may be finally seeing indications of a turn. Writing about the market action on July 11, Jim Furey of Furey Research Partners says, "In response to the CPI, interest rates fell and Small Caps surged

[1] The print edition of the article featured this title. The online version available on Barron's website is titled "*The Magnificent 7 Tech Stocks Aren't Unique – and the Future May Not Belong to Them.*"

3.6% higher while Large Caps fell 0.9% lower, led to the downside by the Magnificent Seven. It was the opposite of the 1H24 relative performance, which was the worst Small Cap 1H relative performance in Russell history. Several more days like yesterday's and Small Caps will again be in vogue."

The next chart takes inspiration from July 11 and expands out to 35 years. In blue is the relative price level of the Towle Composite, net of fees, compared to the S&P 500 (a monthly frequency is the best we can provide). Along the bottom in gray, we show daily performance of the Russell 2000 minus daily performance of the S&P 500*, calling out the July 11 observation along with the seven other largest days in 35 years.



Source: S&P Capital IQ, Yahoo Finance, Towle & Co
**Russell 2000 Minus S&P 500 Daily Performance is scaled to only show when Russell 2000 daily performance is greater than S&P 500 performance*

To put a bow on that chart, we built the table below to show historic forward Towle Composite returns, net of fees, compared to the S&P 500 and Russell 2000 Value following these extraordinary days. **Small-cap value has typically beaten large-cap growth, and Towle's active management has historically beaten the passive index**:

Performance Day	End of Month	3-Year Forward Returns from End of Month (Cumulative)		
		S&P 500	Russell 2000 Value	Towle Composite, Net
04/28/00	04/30/00	-34%	23%	55%
10/10/08	10/31/08	38%	31%	101%
10/04/11	10/31/11	72%	64%	70%
03/19/20	03/31/20	67%	77%	158%
04/09/20	04/30/20	50%	54%	97%
01/06/21	01/31/21	37%	14%	39%
11/14/23	11/30/23	?	?	?
07/11/24	07/31/24	?	?	?
Average		**38%**	**44%**	**87%**

Past performance is no guarantee of future outcome. Please refer to the last page for additional disclosures.

History doesn't repeat, but it often rhymes. We see a confluence of market events today that rhymes with past eras of technology exuberance, now combined with at least one historic day that may have marked a pivot in favor of our small-cap value portfolio. Of course, we have no crystal ball. **But we think it's past time for investors to skate to where the puck is going.**

Quarterly Review

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

Looking Ahead

In our year-end 2023 investor letter, we highlighted the Towle Composite's strong 19% net annual return and called attention to small-cap value's fourth quarter outperformance relative to mega-cap tech stocks. We pointed to value accretive buyout announcements that underscored hidden potential within our portfolio and warned of the possible impact of rising interest rates on mega-cap tech valuations. With strong returns from our consumer discretionary, materials, and energy holdings, the stage was set for the long-awaited rotation into small-cap value.

Unfortunately, the first half of 2024 experienced a resurgence in mega-cap tech stocks seemingly at the expense of the Towle portfolio, reversing the previous momentum of our fundamentally sound, undervalued small cap equities. Fittingly, some of our strongest performers from 2023 now rank among the weakest performers this year, despite showing no evidence of reduced earnings capacity or balance sheet fragility.

Interest in small-cap value seems to again be on the rise, and we take comfort in the ongoing benefits our companies derive from a strong U.S. private sector. Household and corporate balance sheets have strengthened significantly since the 2008-09 Financial Crisis, debt servicing remains low, and liquidity is ample. Furthermore, U.S. corporate debt-to-equity is near a post-WWII low and net corporate cash flow to GDP is near a post-WWII high. **With such a supportive environment and strong company fundamentals, we are surprised the Towle portfolio has underperformed to such a degree but believe today's bifurcated market is unsustainable and near a turning point.**

Bolstered by lower-than-expected CPI and renewed expectations for a September rate cut, we are most encouraged by the market's historic pivot on July 11 towards small-cap value equities. While this may or may not be the watershed moment of 2024, it's certainly reminiscent of past market turns.

Amidst this developing backdrop, the Towle team stands resolute, championing our data-driven investment process focusing on overlooked, deeply discounted companies. With significant personal capital on the line, the Towle team remains fully committed, investing alongside our clients and waiting patiently for the tide to turn.

We are delighted to welcome Haley Sawyer as our new Investor Relations Associate. In her new role, she shares responsibility for administering day-to-day business operations with a focus on marketing strategies and growth opportunities. Haley previously held the position of Management Consultant in the Strategy and Analytics practice at Deloitte where she gained experience in various industries, including Financial Services. We look forward to seeing all the ways her energy, work ethic, and collaborative spirit impact the firm's development.

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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. 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.4) 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.