TOWLE & CO.
DEEP VALUE INVESTING
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Encouraging! The strong performance trends that started in the second quarter continued through September. For the two-quarter period ending September 30, 2020, the Towle Deep Value Composite returned 54.6% gross of fees versus 21.9% for the Russell 2000 Value and 31.3% for the S&P 500. While this degree of outperformance coming off cyclical bear market lows has historically foreshadowed a sustainable move in economically sensitive stocks, short-term prospects remain uncertain as the market wrestles with the impact of a stubborn pandemic, unresolved stimulus plans, and heightened political tensions. However, as long-term investors, we are encouraged that both consumer and business confidence are on the rise and that leading indicators of U.S. economic activity continue to improve[1]. We believe these positive trends will support a cyclical earnings recovery in 2021 and beyond, igniting renewed interest in mispriced deep value equities.

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

Periods ending 9/30/20	*Towle DVC (Gross of fees)*	*Towle DVC (Net of fees)*	*Russell 2000 Value*	*S&P 500*
3 months	10.03%	9.83%	2.56%	8.93%
1 year	-13.21	-13.85	-14.88	15.15
3 years	-10.93	-11.60	-5.13	12.28
5 years	4.93	4.16	4.11	14.15
10 years	7.25	6.49	7.09	13.74
20 years	11.32	10.48	7.40	6.42
30 years	13.91	13.10	10.50	10.59
Inception (1/1/82)	14.39	13.57	10.80	11.71

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

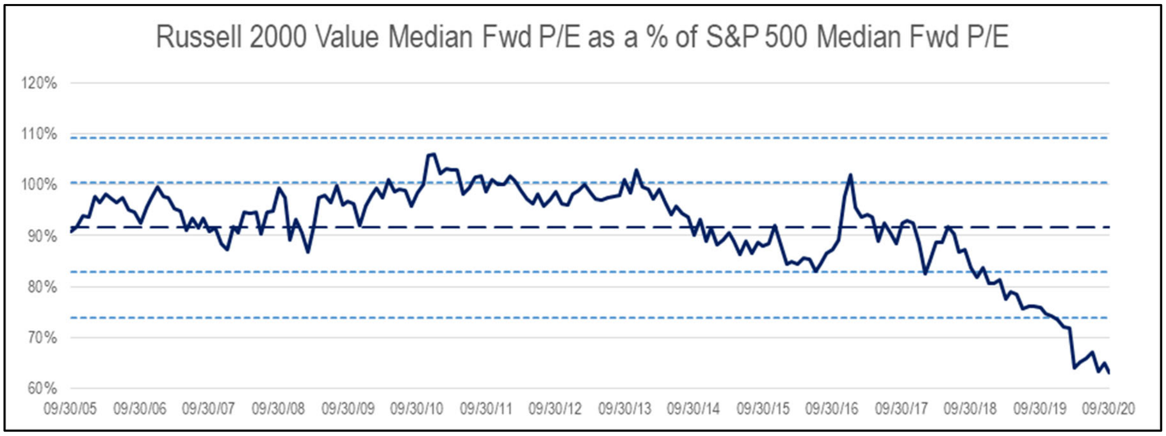
With a once-in-a-century pandemic shutting down much of the global economy, 2020 has been like no other period in our lifetimes. Fortunately, federal governments and central banks around the world responded with extraordinary levels of fiscal and monetary stimulus. As we highlighted in our second quarter letter, the U.S. Federal Reserve committed to do "whatever it takes" to support the economy. This quarter, the Fed announced a substantial policy shift on inflation, indicating that inflation would be allowed to run higher than the standard 2% target before raising interest rates. This stand-on-the-gas approach supported by most Fed officials indicates a penchant to maintain rates near zero through 2023.

Accordingly, the U.S. economy has responded – but the response, to date, has favored the few over the many. The COVID-19 era continues to create outsized challenges for the more traditional, economically sensitive participants that include the deep value investment landscape. Conversely, the current stay-at-home economy has acted as an accelerant for "the few" large technology platforms, those colloquially referred to as the FANGMAN stocks (Facebook, Apple, NVIDIA, Google, Microsoft, Amazon, and Netflix). To put this disparity in context, consider the returns of the market cap weighted S&P 500, in which the FANGMAN stocks represent about a quarter of the index, compared to the equally weighted S&P 500, in which the seven represent about 1.5%. For the first nine months of 2020, the market cap weighted S&P 500 was up 5.5%. Over the same period, the equally weighted S&P 500 was down 4.8%. In fact, nearly 60% of S&P 500 constituents are still down year-to-date. It is the few that have carried the day.

In addition, the valuation dispersion between large-cap growth and small-cap value remains extreme. To illustrate the imbalance, consider the relationship between the median forward price-to-earnings (P/E) ratios of the Russell 2000 Value (IWN) and the market cap weighted S&P 500 (SPY) as proxies for small-cap value and large-cap growth, respectively.

[1] Source: The Conference Board Leading Economic Indicators index, comprised of 10 indicators, has been in an uptrend since June.

The chart below depicts IWN's median forward P/E as a percentage of SPY's median forward P/E. The dark blue dotted line just above 90% shows the average discount of value to growth over the past 15 years, with the light blue dotted lines showing the first and second standard deviations above and below the average:



Source: S&P Capital IQ

Our space appears to be currently valued at a statistically significant discount. How does the Towle Deep Value portfolio compare? The table below details quarter-end median forward P/Es and their mathematical inverse, the forward earnings yield:

As of 9/30/20	**Median Forward P/E**	**Earnings Yield**
S&P 500 (SPY)	18.9x	5.3%
Russell 2000 Value (IWN)	11.9x	8.4%
Towle Deep Value	9.6x	10.4%

Source: S&P Capital IQ

While we know not if, when, why, or how this valuation/performance gap between growth and value will close, our near 40-year history indicates that patient value-oriented investors have been rewarded over time.

Portfolio Review

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

Looking Ahead

Noteworthy economic indicators encompassing employment, manufacturing, consumer confidence, goods transport, and interest rates have continued to slowly build off the lows of the spring and early summer. Since the end of June, steady improvement has been measured in the Conference Board Leading Economic Index, the Economic Cycle Research Institute Index, and the New York Fed Weekly Economic Index, among others. While we cannot be certain of the future, this supportive economic advancement is encouraging.

If history is any indication, one of the best times to be a small-cap, deep-value investor is at the beginning of a new economic cycle. In his letter dated September 22, 2020, Leuthold Group Strategist Jim Paulsen argued that "broader stock-market plays beyond new-era technology and communications…including cyclical sectors, small caps, value stocks, and international investments – seem poised to take a more significant leadership role" under a renewed economic cycle. Is the long-discussed valuation dispersion between smaller-cap cyclicals and larger-cap technology companies near a tipping point?

While the short-term macro picture remains foggy, the Towle team is finding green shoots at the micro level. Specifically, companies have been able to utilize the "shield of the virus" to rationalize cost structures. These improved cost structures are already elevating profit margins within our portfolio and could launch structurally higher future earnings. It is our view that the opportunity that lays before deep value investors can best be summed up by Jim Paulsen: "In the name of survival, [companies] have been forced to significantly cut costs, improve efficiencies, and lower break even points. Consequently, the most economically sensitive companies…may currently be positioned with the greatest upside profit leverage of the post-war era, just ahead of a pending 2021 economic boom."

At Towle & Co. we believe in the certainty of progress, the continuity of good, and the inherent optimism of the human spirit. Consequently, over the course of our nearly 40-year history, we have sought opportunity during periods of short-term market uncertainty. Today, as always, we continue to patiently invest for the long term with a quiet conviction that time is on our side.

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