TOWLE & CO.

Deep Value Investing

April 15, 2022

Staying disciplined! The Russian invasion of Ukraine further disrupted supply chains in the first quarter of 2022, introducing higher levels of uncertainty. Growing concerns about increasing inflation and rising interest rates followed. As central banks pivoted to a new policy regime, complacent investors, accustomed to persistently low interest rates, were caught flat-footed.

Uncertain environments are generally uncomfortable. But in times like these, we find refuge in the deep value investment process. Our strict valuation discipline has been fruitful over the long term, and we believe should be particularly effective as rising interest rates reveal the value of current real earnings while pressuring multiples across highly valued sectors of the equity market.

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

Periods ending 3/31/22	*Towle DVC (Gross of fees)*	*Towle DVC (Net of fees)*	*Russell 2000 Value*	*S&P 500*
3 months	2.16	1.97	-2.40	-4.60
1 year	1.11	0.39	3.32	15.65
3 years	15.18	14.34	12.73	18.92
5 years	5.76	4.98	8.57	15.99
10 years	12.52	11.72	10.54	14.64
20 years	11.66	10.82	8.55	9.25
30 Years	14.07	13.25	10.60	10.57
Inception (1/1/82)	15.45	14.62	11.79	12.13

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 persistent inflation, rising interest rates, ballooning energy prices, and heightened geopolitical tensions, the first quarter proved turbulent. As Strategas Securities, LLC (Policy Outlook, April 5, 2022) points out, the markets haven't seen the combined tensions of inflation, a midterm U.S. election, and Russian aggression since 1982, the first year of Towle & Co's history. Perhaps more interestingly, the quarter's activity highlights the apparent futility of precise forecasts.

Consider inflation. In 2021, the Federal Reserve routinely described increasing prices of goods and services as transitory. That narrative has changed notably, along with the Fed's median estimate for year-end 2022 PCE inflation which is up from 2.6% to 4.3% in just three months. The path of interest rates has similarly been miscalculated. Market expectations for 2022 Federal Funds Rate activity moved from three or four rate hikes of 25 basis points to seven or eight rate hikes, some of which may be 50 basis points. Clearly, rates are very difficult to forecast.

Is the investment community any better at forecasting prices? Consider energy. Driven in part by the consequences of the Russian invasion of Ukraine, the prices of oil and natural gas skyrocketed in the first quarter. Subsequently, energy stocks responded as shown by the 39% three-month rise in the Energy Select Sector SPDR Fund (XLE). Energy prices: difficult to forecast.

Another unanticipated change has been the reordering of global supply chains. We are now witnessing a move towards onshoring or even "ally-shoring" of production, as businesses increasingly abandon the efficient but fragile nature of just-in-time supply chains. We do not know what the end effect will be nor can we have any estimate how long this shift towards deglobalization will take. But what a shift it has been.

Clearly, the investment environment has entered uncharted territory, impelling Towle & Co. to ponder the course ahead. Our recommendations for the deep value investor are outlined in the Looking Ahead section. As you might guess, we remain bullish on the human spirit and the certainty of progress, and we believe that steadfast adherence to the disciplined deep value process remains as important as ever!

Portfolio Review

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

Looking Ahead

Our success as deep value investors depends on our ability to see the world differently than the majority. To that end, we want to make a few points about human nature and how we utilize our contrarian lens.

Human nature prefers stability over instability. Therefore, human nature also has a fundamental desire for the world to be predictable, because unpredictability is unstable. But wanting the world to be predictable does not make it so. In fact, unpredictable events are guaranteed to happen, and humanity's desire for predictability can result in the design of fragile systems which, in a world full of surprises, only exacerbates the ensuing instability. Add to this the increasing amounts of fiscal and monetary intervention, which would appear to make the world more certain and more predictable, but often have the opposite effect. For markets, continued volatility is all but guaranteed.

Look no further than our Investment Environment section for examples. The Fed's estimate for year-end 2022 inflation is up 65% in just three months. Market expectations for interest rate hikes are up 2x. Energy, the worst-performing sector of the decade, outperformed all other sectors substantially over the last three months. The system underpinning the global movement of goods is now in question, due in large part to an invasion in Europe that few saw coming and arguably few thought would be material to markets and the world economy. To top it all off, the CBOE Volatility Index (VIX) averaged its highest quarterly level since the fourth quarter of 2020.

What is the deep value investor to do? We are reasonably certain about a few things. First, while equities are priced on expectations about the future, those expectations can turn out to be radically wrong. Second, we know how to identify what a cheap stock looks like in our deep value space. Third, we believe that human nature's effects on markets will continue to produce volatility and mispriced securities. And lastly, we feel certain that mankind is consistently progressing forward, giving us steady optimism about the long term.

At Towle & Co. our process focuses on buying stocks that 1) trade at a low multiple of sales and 2) exhibit the potential to generate significant earnings relative to their market value. Low sales multiples allow us to acquire what we feel is substantial economic activity on the cheap, and this solid base of business often allows ample opportunities to improve profitability. In a world that despite human nature's desires is full of surprises, the best we can do is take advantage of volatility and keep recycling our collective capital into stocks trading at attractive valuations. "Price is king" after all, and a depressed valuation likely reflects the market's unfavorable view of the company, limiting further declines should the anticipated, adverse outcomes occur. But should those negative expectations prove incorrect, the stock is likely to surprise to the upside, with the potential to provide remarkably high returns.

We have two key changes to our senior leadership team to announce.

Jack Gillis has joined Towle & Co. as Head of Client Relations, effective this month. He has primary responsibility for strengthening investor relationships and helping the firm to capitalize on growth opportunities. A highly productive and respected financial executive, Jack spent the last 33 years in relationship management roles at J.P. Morgan Private Bank, National City, A.G. Edwards, and Lehman Brothers. As a longtime client and friend of Towle & Co., he understands and appreciates our core investment strategy and unique culture. We are overjoyed that Jack has agreed to share his vast experience, refined approach, and service mentality with us, and know he will play a key role in the firm's long-term growth and development. Jack is based in his hometown of St. Louis, MO.

Several months ago, Joe Bradley informed us of his decision to retire from Towle & Co. by June 2022. It's not often an executive gives such advance notice to facilitate their own transition plan! Well, that's just how Joe rolls. After nearly 14 years at Towle & Co., culminating in his appointment as Chief Operating Officer and Director of Client Relations, Joe has served our investors, trade partners, and teammates with the utmost grace, thoughtfulness, and care. His remarkable contribution to the firm's development combined with a tender but tenacious approach to his work leaves a rich legacy for us to honor and sustain. We are immensely grateful that Joe shared his many talents with us and know that new adventures will bring fresh opportunities to bless others as he has blessed us.

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

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