TOWLE & CO.

Deep Value Investing

July 18, 2022

About-face! Against a backdrop of geopolitical tensions and lingering supply issues, the second quarter of 2022 marked a critical shift in Federal Reserve posture. U.S. monetary policy flipped from supporting full employment to fighting inflation.

Led by our energy holdings and supported by a modest cash position, the Towle portfolio was down -10.4% in the second quarter. This compares with the Russell 2000 Value down -15.3% and the S&P 500 down -16.1%. As we have noted in previous letters, the mathematics of rising interest rates places a greater valuation emphasis on real, nearer-term profits. We remain confident in our deep value portfolio of real earners.

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

Periods ending 6/30/22	*Towle DVC (Gross of fees)*	*Towle DVC (Net of fees)*	*Russell 2000 Value*	*S&P 500*
3 months	-10.40	-10.59	-15.28	-16.10
6 months	-8.47	-8.83	-17.31	-19.96
1 year	-8.61	-9.30	-16.28	-10.62
3 years	11.99	11.17	6.18	10.60
5 years	4.76	3.99	4.89	11.31
10 years	12.45	11.64	9.05	12.96
20 years	10.71	9.88	7.77	9.08
30 Years	13.53	12.71	10.07	9.86
Inception (1/1/82)	15.03	14.21	11.26	11.57

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

For the first time in a generation, U.S. monetary policy has entered a new regime. Since the early 1980s, globalization and productivity growth created economic slack, enabling central banks to maintain persistently low interest rates. Seemingly elusive inflation permitted an accommodative Fed to cut rates and prop up the economy after almost every downturn. But after a decade plus of anemic growth and under-investment, culminating in a deluge of pandemic-related monetary and fiscal stimulus, inflation has returned in earnest, becoming the Fed's number one priority.

Our central bank's about-face has rattled capital markets. The combined U.S. equity and fixed income markets have declined by $23 trillion, representing a greater percentage of GDP than the corresponding decline represented during the Great Financial Crisis of 2008/2009. And according to an analysis done by Deutsche Bank, U.S. 10-year Treasuries just completed their worst first half of any year since 1788! As history reminds us, bubbles eventually pop. We are therefore grateful for an investment process that prioritizes sound valuation above all else.

If onerous inflation readings persist, the Fed may have to push to catch up, potentially driving the economy into recession. If inflation moderates, central bank policy may ease, an historically supportive outcome for our economically sensitive portfolio. Fortunately, the Towle team is seeing evidence of inflation-reducing green shoots in multiple places:

- Companies are reporting shorter cycle times, improved inventory positions, and stabilizing build cycles.
- Surveys in June of five Federal Reserve Banks "strongly suggest that supply chain disruptions have eased significantly in recent months," as measured by regional unfilled orders or delivery times (Yardeni Research, June 28, 2022).
- The Bloomberg Commodity Index, a broadly diversified price index of physical commodities including energy, grains, and metals, is down 20% from its June high.

One last green shoot for equities has been the dramatic rightsizing of corporate cost structures over the past two years. As we've touched on in previous letters, the pandemic forced management teams to cut expense structures and "get into fighting shape." Today, many companies are better positioned for good times and bad, with considerable operating leverage to the upside and reduced financial leverage to the downside. Though the future is uncertain, we believe corporate America may be more ready than ever for what comes next.

Portfolio Review

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

Looking Ahead

The economic future remains unknowable with any precision. Adam Tooze, Professor of History at Columbia University, sums it up quite well in his Chartbook #131: *"…In the last 18 months we have seen the fastest global growth in 50 years, followed by the most rapid slowdown, creating what is in the BIS's view* [Bank of International Settlements]*, a global economic configuration unprecedented in history…In the current conjuncture, if you aren't puzzled you don't get it."* The Towle team indeed feels puzzled, but we also aren't sure we get it.

Even so, in our opinion the Federal Reserve's changing stance on inflation cannot be overstated. For the first time in four decades the Federal Reserve appears to be prioritizing the fight against inflation over maintaining full employment. Their primary tool in this fight is to raise interest rates, and these higher rates change the mathematics of investing. Bonds lose value as rates rise. Growth assets like technology stocks, which promise profitability sometime in the future, lose value as those far-out cash flows are discounted back to present at higher discount rates. Speculative assets like cryptocurrencies lose value as the music stops and investors realize there aren't enough chairs.

In contrast, the Towle portfolio is dominated by businesses that own real assets and produce real profits. According to consensus estimates, the median earnings yield on the Towle portfolio based on 2023 earnings sits at 16.5%, without a single portfolio company expected to post negative earnings. We are delighted to hold a deep value portfolio like ours at a time when investors are starting to pay attention to earnings and valuation, and we aren't alone. Cliff Asness of AQR Capital Management recently told the WSJ, "People like me, both for legal and for honesty reasons, should never use the word guarantee, and I won't. But I've never been more excited about value." The Towle team may not be as bold as Cliff, but we wholeheartedly embrace the spirit of his comment.

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