TOWLE & CO.

Deep Value Investing

January 13, 2023

Poised! Rising interest rates and higher inflation transformed the investment environment in 2022. Famed credit investor Howard Marks recently described the transformation as a "sea change,"[1] while *The Economist* ran an edition last month subtitled "The new rules of investment."[2] Volatile crosscurrents including persistent inflation, a hawkish Fed, and stubborn geopolitical tensions set a cloudy tone, presenting the kind of opportunity-rich environment coveted by value investors.

Fittingly, we are optimistic that the "new rules" include a back-to-basics emphasis on valuation. Indeed, the new interest rate regime, in combination with strong energy sector performance and selective cash management, propelled Towle Deep Value's outperformance in 2022 over the benchmarks below. Going forward, the era of free money is likely over as higher interest rates compress valuation multiples and highlight the importance of current earnings and cash flows. With the Fed's ongoing removal of excess liquidity and the normalization of interest rates, we believe corporate earnings and valuation will drive returns in 2023 and beyond.

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

| *Periods ending 12/31/22* | *Towle DVC (Gross of fees)* | *Towle DVC (Net of fees)* | *Russell 2000 Value* | *S&P 500* |
|---|---|---|---|---|
| 3 months | 15.37% | 15.08% | 8.42% | 7.56% |
| 1 year | -1.67 | -2.64 | -14.48 | -18.11 |
| 3 years | 10.27 | 9.17 | 4.70 | 7.66 |
| 5 years | 2.77 | 1.75 | 4.13 | 9.42 |
| 10 years | 11.30 | 10.20 | 8.48 | 12.56 |
| 20 years | 12.09 | 10.98 | 8.99 | 9.80 |
| 30 Years | 12.88 | 11.77 | 9.61 | 9.65 |
| Inception (1/1/82) | 15.04 | 13.90 | 11.20 | 11.48 |

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

## 2022 in Review

The secular change in the direction of interest rates caused much angst for professional and individual investors alike. Other than cash and energy stocks, there was nowhere to hide. The S&P 500 declined 18.1%, the Russell 2000 fell 20.4%, and the Nasdaq plunged 32.5%. Notably, numerous "must own" growth stocks fell more than 50% in 2022 with Amazon, Meta, and Netflix finishing below pre-pandemic levels. And to top it all off, bonds had their worst year in over a century.

Thankfully, we navigated the upheaval of 2022 quite well, showcasing the power of low valuations and a well-developed investment process. Based on our analysis, our outperformance boiled down to three key factors:

1. Exposure to the energy sector,
2. Risk management at the portfolio level through cash positioning,
3. Risk management at the position level by divesting companies when the investment thesis was no longer valid.

Heading into 2022, the Towle portfolio held a large 15% weighting in the energy sector compared to 4% for the Russell 2000 Value. We believed (and still do) that supply was (and remains) structurally constrained due to years of underinvestment. While renewables should steadily gain market share, fossil fuels are still the major contributor to

[1] Howard Marks, "Sea Change," Oaktree Capital Management, 12/13/22.
[2] The Economist, "The New Rules of Investment," 11/30/22.

economic activity due to their high energy density, wide availability, and lower cost. With no immediately available fix to the energy supply issue and the potential for increased energy demand from China's economic reopening in 2023, we maintain exposure to the energy sector as earnings prospects and valuations remain attractive.

The extreme price volatility and dynamic risk environment of 2022 afforded the opportunity to actively manage our cash position. At various instances throughout the year, we held up to 15% cash in our model portfolio. This allowed us to be more defensive from a position sizing perspective and more opportunistic when prices fell.

At the individual position level, we managed risk by selling companies when the investment thesis was no longer valid, regardless of a position's gain or loss. Executing this type of discipline is likely the most difficult aspect of portfolio management, particularly given our deep value orientation and propensity to average down when a company's stock price falls. Selling losers at a large capital loss substantiates that we were wrong, but it's often the right move from a risk management and capital preservation perspective if our investment thesis no longer applies.

A willingness to walk away from companies with a broken investment thesis, in combination with our energy holdings, valuation focus, and portfolio-level risk management activity, helped us outperform against both benchmarks in 2022.

## Quarterly Review

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

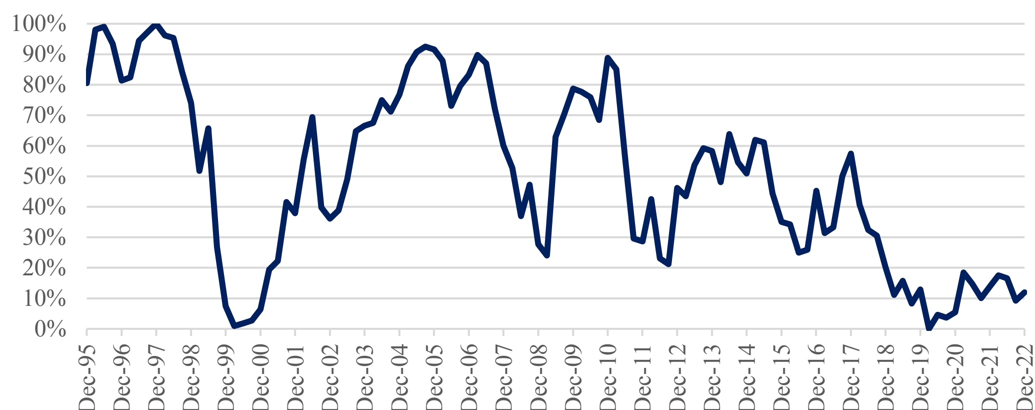
## Looking Ahead

The range of possible outcomes for inflation, Fed policy, and economic growth remains wide and futile to predict. Despite the uncertainty, our investment team remains dedicated to identifying deeply undervalued companies trading at low multiples to revenue with the potential for unexpected positive surprises. This approach should allow us to get ahead of improving investor expectations and capitalize on the behavioral inefficiencies in the market. Due to the inherent biases of human nature, the opportunity to defy gloomy expectations is a recurring theme for the seasoned deep value investor. That said, we believe the current deep value opportunity is quite attractive and have several reasons for being especially optimistic:

1. **Upside Potential**: For the past 20 years, we have monitored our portfolio's upside potential, a weighted average differential between each portfolio company's stock price and our internal sell target. At year end, the upside potential was in the top 20% of its historical range.

2. **High Forward Earnings Yield**: Based on analyst estimates via industry database Capital IQ, the earnings yield (representing estimated earnings per share divided by stock price) on the S&P 500 for 2023 is just 6%, while the earnings yield on the Towle portfolio is 15%. Might investors be attracted to the higher return potential in deep value?

3. **Deep Value Is Still Very Cheap**: We looked at the price-to-sales ratio (PSR) of the largest 2,000 U.S. stocks going back to 1995. Specifically, we divided these 2,000 stocks into deciles ranked by PSR on a quarterly basis. As of 12/31/22, the cheapest decile, which includes most of the names we own, was only at its 12th percentile versus the overall median, near the lows of the entire timeframe. A chart of this historical percentile is below. Interesting to us is the comparison of March 2020 to March 2000, the only two quarter-ends in these 27 years when the cheapest decile bottomed out vs. the broader market. We keep a keen eye out for good value runs, and 2003-2006 saw quite a rotation to our space.




In short, valuations in our space look compelling, our specific portfolio has attractive upside potential, and it is possible – perhaps even likely – that security prices already reflect depressed investor expectations. Yet, there is no certainty, so we remain vigilant about the key risks to the portfolio. As recent quarterly earnings have shown, many of our holdings have been successful in passing on rising costs and maintaining profit margins. We are closely monitoring earnings releases and conference calls to anticipate the potential impact of inflationary cost pressures on our portfolio companies and sell targets.

Looking ahead to 2023 and beyond, our disciplined investment process and focus on valuation enable us to embrace uncertainty as an opportunity. In addition, our portfolio is strategically positioned in essential industries grappling with long-term underinvestment that we believe are now poised for strong earnings and cash flows (such as energy and refining, automotive manufacturing, homebuilding, and steel production). While the path ahead may seem uncertain to some, we are confident in our ability to execute our deep value strategy through the market cycles, as we have done since our founding in 1981.

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