

TOWLE & CO.

Deep Value Investing

April 19, 2023

Normalizing interest rates triggered a whirlwind first quarter for markets. Despite the Towle Deep Value Composite's January return of 14% net of fees, we finished the quarter up just 1% as interest rate-driven stress in the banking system curtailed January's optimistic run.

We are looking forward to more normal capital markets. Interest rates near zero are neither normal nor healthy, as they typically give rise to bloated asset values, misallocations of capital, and irresponsible levels of debt, among other things. Higher rates demand a more disciplined approach to capital allocation and refocus investors on appropriate valuation. Investing in a near-zero interest rate environment feels foreign. We much prefer interest rates where they are today.

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

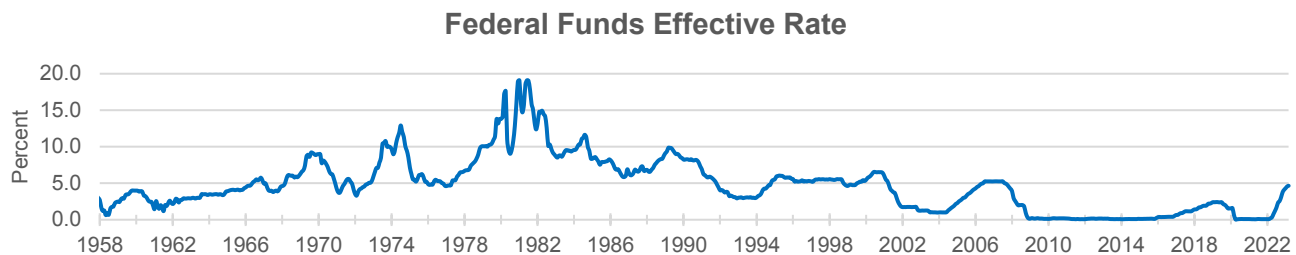
<i>Periods ending 3/31/23</i>	<i>Towle DVC (Gross of fees)</i>	<i>Towle DVC (Net of fees)</i>	<i>Russell 2000 Value</i>	<i>S&P 500</i>
3 months	0.88%	0.63%	-0.66%	7.50%
1 year	-2.90	-3.84	-12.96	-7.73
3 years	38.51	37.14	21.01	18.60
5 years	4.93	3.90	4.55	11.19
10 years	9.75	8.66	7.22	12.24
20 years	12.23	11.11	9.24	10.37
30 Years	12.38	11.26	9.24	9.75
Inception (1/1/82)	14.96	13.82	11.11	11.61

*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

The loudest news of the first quarter concerned Silicon Valley Bank, Signature Bank, First Republic Bank, and Credit Suisse. SVB's implosion occurred with incredible speed, and investors quickly became fearful about the prospects of many mid-sized regional banks. Fortunately, these bank failures did not arise from loan defaults due to a weakening economy. Instead, the banking stress in the first quarter was a direct effect of mismanaged interest rate risk. We do not believe that a 2008 scenario is probable, largely due to banking reserves and capital ratios that are far superior to those in the 2008 period. But further discussion about these interest rates is warranted.

Following the financial crisis of 2008-2009, the Federal Reserve logically pushed rates towards zero. Fostering liquidity and supportive credit conditions was of the utmost importance given the emergency of the Global Financial Crisis. However, the Fed then kept the Fed Funds Rate near zero until 2015 and below 2.5% until 2022:



Source: FRED

We do not know what the long-term optimal rate is, but we are reasonably confident that zero is an incorrect long-term level. The first-order effects of near-zero interest rates generally include increasing debt levels and the greenlighting of corporate finance projects that would fail to clear a normal NPV hurdle. Second-order effects can include insatiable risk

appetites, ever-expanding multiples on growth assets, a shift away from active investment management, and the zombification of companies that would otherwise cease to exist.

Incentives that encourage malinvestment are harmful. A recent WSJ article pointed out, “Nothing is as expensive as free money.” And in an interview from March 7, 2023, Oaktree’s Howard Marks perhaps said it best: “I think we lived through an abnormal environment from 2009 to 2021 in which interest rates were zero most of the time... Why would you keep the Fed Funds rate at an emergency level? Interest rates of zero is kind of like adrenaline... Nobody starts their day with a daily injection of adrenaline for 7 years. That’s not very healthy.”

Based on the past century, a normal economy with normal financial markets would include modest inflation and low-to-mid single digit interest rates. Importantly, these are conditions that support active investment management. Available, reasonable options for achieving investment returns force capital discipline in a way that we haven’t seen for many years. We know of clients and friends who are purchasing treasuries for the first time in their lives, while others are allocating to money market funds yielding more than 5%. Growth-at-any-price appears to be over, for now. Therefore, as we detail below, we are confident in the long-term appreciation potential of the Towle Deep Value portfolio, especially in today’s normalizing investment environment.

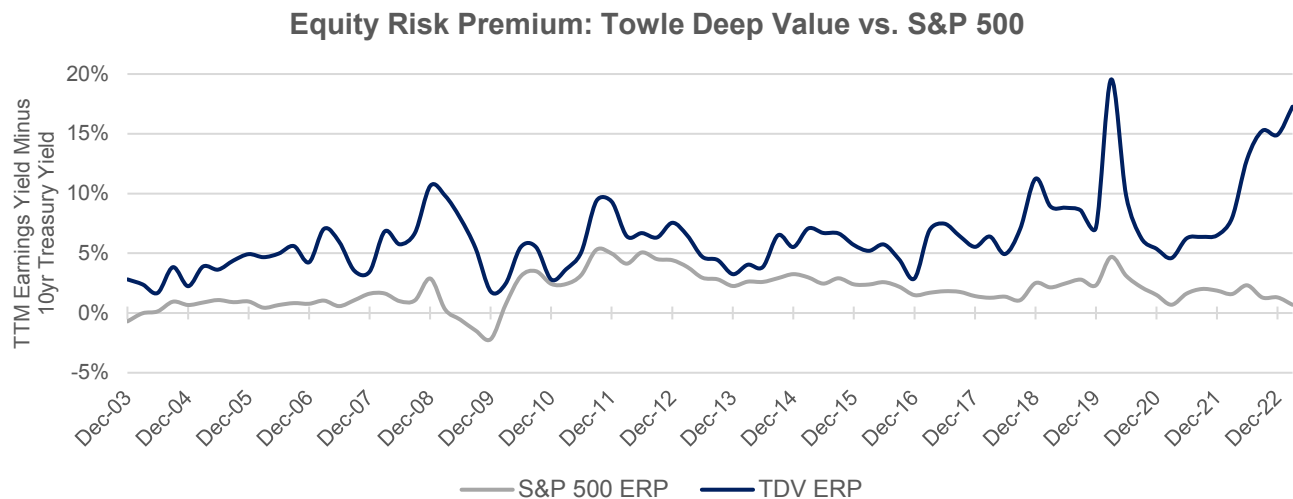
Quarterly Review

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

Looking Ahead

On April 6, 2023, the Wall Street Journal published an article titled “Stocks Haven’t Looked This Unattractive Since 2007.” The headline sounds foreboding, but which stocks? Predictably, the article focuses on the S&P 500. Of specific concern is the equity risk premium, or the difference between the earnings yield on the S&P 500 and the yield available on 10-year treasuries. According to the WSJ data, this difference sat at a 15-year low of 1.6% in early April.

At quarter-end, the median trailing earnings yield on the Towle Deep Value portfolio stood at 20.7%, the highest level in two decades. This translates to an equity risk premium (ERP) of 17.3%, where ERP equals TDV median trailing earnings yield less the 10-year treasury yield. In our opinion, the elevated ERP makes the Towle portfolio particularly attractive at this time:



Source: S&P Capital IQ, Towle & Co

The investment community appears fearful of higher rates and their potential impact, but we think the “new normal” of higher rates is less “new” and more “normal.” In fact, a return to higher, more natural rates should support the proper pricing of tangible assets, earnings, and cash flows. We believe our portfolio, consisting of high earners and cash flow generators, is well-positioned for such a return.

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