TOWLE & CO.

Deep Value Investing

July 18, 2023

Turning tide? After two months of decline, the Towle Deep Value Composite's June return of 13% net of fees was a welcome resurgence. Despite finishing the quarter with a modest 0.5% net gain, we are encouraged by the upward momentum which has continued into July.

The much-anticipated recession of 2023 has thus far been avoided. And given the current backdrop of better-than-expected corporate profits, ample investor cash reserves, and resilient employment statistics, the Towle team is feeling optimistic. We think our undervalued, cyclical portfolio is primed for outperformance.

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

Periods ending 6/30/23	*Towle DVC (Gross of fees)*	*Towle DVC (Net of fees)*	*Russell 2000 Value*	*S&P 500*
3 months	0.72%	0.47%	3.18%	8.74%
1 year	9.15%	8.09%	6.01%	19.59%
3 years	23.95%	22.73%	15.43%	14.60%
5 years	4.06%	3.03%	3.54%	12.31%
10 years	8.94%	7.86%	7.29%	12.86%
20 years	11.37%	10.27%	8.29%	10.04%
30 Years	12.31%	11.19%	9.30%	10.04%
Inception (1/1/82)	14.89%	13.75%	11.13%	11.76%

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

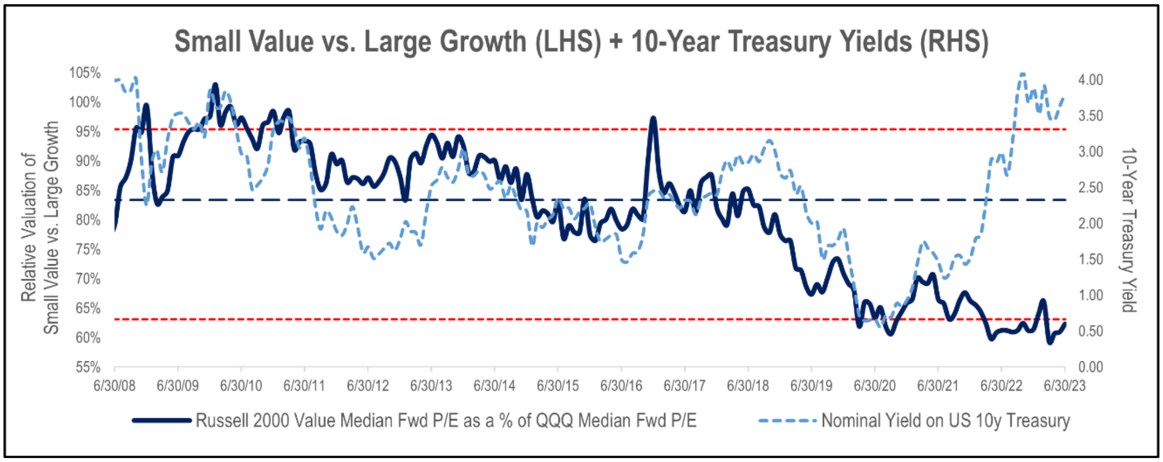
Investment Environment

Investor exuberance is on display, though not broadly distributed. For the first half of 2023, the equally-weighted S&P 500 (RSP) is up 7%, the market cap-weighted S&P 500 (SPY) is up 17%, and the Nasdaq-100 (QQQ) is up nearly 40%, exhibiting the influence of a handful of megacap technology stocks.

The poster child for investor exuberance is Nvidia, which now sports a $1 trillion valuation on just $26 billion of trailing sales – sales that, surprisingly, are *down* year-over-year. Nvidia's current valuation reminds us of the 2002 comment by Scott McNealy, co-founder of Sun Microsystems, about his company's valuation during the dot-com bubble. He pointed out that to deliver a 10-year return to shareholders with Sun trading at 10x revenue, the company would have to distribute 100% of revenues as dividends every year for 10 years. That assumes zero cost of goods sold, zero operating expenses, zero R&D, zero tax expense, and the ability to slip tax-free dividends to shareholders. McNealy aptly concluded his statement with the question, "What were you thinking?" Nvidia is currently trading at nearly 40x revenue. Consider that math!

Speaking of math, Apple's market capitalization now surpasses the collective value of *all* the companies in the Russell 2000 Index. Moreover, the top 10 stocks in the S&P 500 have a combined market capitalization exceeding $12 trillion. A mere 10% reallocation away from these 10 stocks would amount to $1.2 trillion – more than 50% of the entire market value of the Russell 2000 Index.

The chart below revisits the valuation divergence of small-cap value versus large-cap growth. Specifically, we show the median forward P/E for the Russell 2000 Value (IWN) as a percent of the median forward P/E for the Nasdaq-100 (QQQ). Dotted red lines represent the 10th and 90th percentile values, while the dark blue dotted line shows the median. Given the current interest rate environment, small-cap value appears underappreciated and poised to perform.



Source: S&P Capital IQ, FRED, Towle & Co.

What if the herd decides to take some gains on the megacaps and reallocate to more valuation-friendly investments? The stage could be set for a sizeable shift of investment capital. Meanwhile, we remain focused on our differentiated deep value strategy, patiently waiting for the short-term voting machine to become a long-term weighing machine.

Quarterly Review

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

Looking Ahead

We believe conditions are particularly ripe for long-term deep value outperformance:

1. **Attractive Valuations**: The relative valuation chart in our Investment Environment section highlights the current, striking cheapness of small value.

2. **Historical Return Pattern**: Our trailing performance leads us to believe that the next 5+ years could be particularly rewarding. Inspired by work from Royce Investment Partners, we found that, since inception and net of fees, our Towle Deep Value Composite has averaged 21% annualized returns for 5-year periods that follow 5-year periods with annualized returns below 5%. The Composite's trailing 5-year annualized return at quarter-end was a dismal 3.0% net of fees.

3. **Supportive Environment**: Favorable conditions supporting industrial growth in the U.S. bolster confidence in our portfolio's potential. At quarter-end, the Towle model portfolio had sector exposures of 20% materials, 20% energy, and 5% industrials. As such, we are well-positioned to benefit from heightened demand for raw materials and energy driven by the newly enacted $2 trillion infrastructure package. The Brookings Institute is predicting "The Start of America's Infrastructure Decade," while Joe Quinlan of Bank of America says, "the U.S. is in the early stages of a manufacturing supercycle."

In today's uncertain economic landscape, investors have understandably flocked towards the perceived safety of megacap tech stocks. However, seasoned investors can attest that in the long run it pays to be on the right side of valuation. Time will tell, but we think the Towle portfolio is there.

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