TOWLE & CO.

Deep Value Investing

October 16, 2023

Stay the course! Rising interest rates, higher oil prices, and a weakening consumer brought volatility in August and September that offset much of July's strong net 9.0% return for the Towle Deep Value Composite. Even still, we are encouraged that the quarter's modestly positive results outperformed its benchmarks.

While we cannot predict whether the currently mixed economic backdrop will worsen or improve, we remain confident in our time-tested investment process. We continue to believe elevated valuation risk exists in broader equity markets creating stark contrast to our undervalued portfolio. With our own capital invested right alongside yours, we'll remain in our seats, confident that the tide will eventually turn in our favor.

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

Periods ending 9/30/23	*Towle DVC (Gross of fees)*	*Towle DVC (Net of fees)*	*Russell 2000 Value*	*S&P 500*
3 months	0.30%	0.06%	-2.96%	-3.27%
1 year	17.58	16.43	7.84	21.62
3 years	20.19	19.01	13.32	10.15
5 years	3.49	2.47	2.59	9.92
10 years	7.69	6.62	6.19	11.91
20 years	10.89	9.79	7.73	9.72
30 Years	11.88	10.77	8.90	9.83
Inception (1/1/82)	14.80	13.66	10.98	11.59

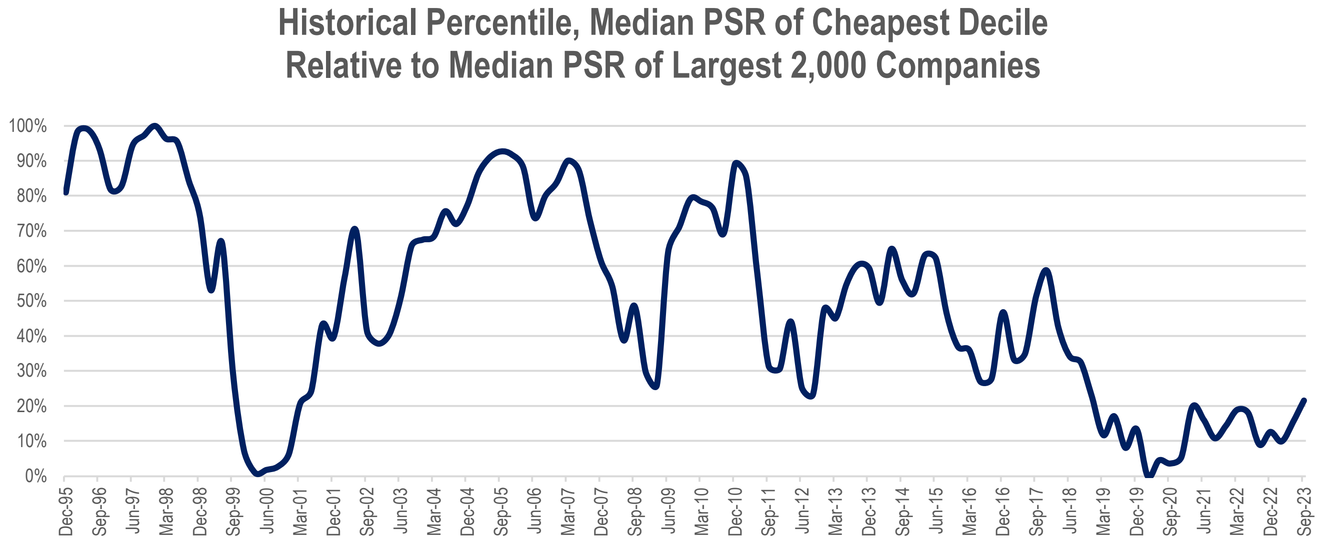
Returns are preliminary and subject to change. Past performance is no guarantee of future outcome.
Please refer to the last page for additional disclosures.

Investment Environment

Benjamin Graham famously asserted that the market functions as a voting machine in the short run and a weighing machine in the long run. We completely agree. If only we could determine how long the short-run voting will persist! Consequently, let us revisit some points from prior commentaries and provide a status update on today's investment environment.

In our Q4 2021 commentary, we highlighted the rise in 10-year U.S. Treasury yields to 1.78% and proposed the following implications for investors in a rising rate environment: near-term earnings increase in value; speculation diminishes; and real assets perform well. Fast forward to today, the 10-year U.S. Treasury yield now stands at 4.72%, marking a 165% increase from early 2022. So, what transpired since then? From 12/31/21 to 9/30/23, the S&P 500 is down -7.4%, the Russell 2000 Value is down -14.9%, and the Towle Deep Value Composite is down just -1.5% net of fees.

In our Q4 2022 commentary, we highlighted that deep value was still historically cheap. We illustrated this by looking at the largest 2,000 U.S.-listed companies dating back to 1995 and showed the median price-to-sales ratio for the cheapest 200 (the bottom decile) vs. the median price-to-sales ratio for all 2,000. At that time, this ratio was near its 10^{th} percentile, indicating that the cheapest 200 companies were *historically* cheap relative to the whole group. Today, still cheap, our deep value space may also be showing signs of life under the surface:

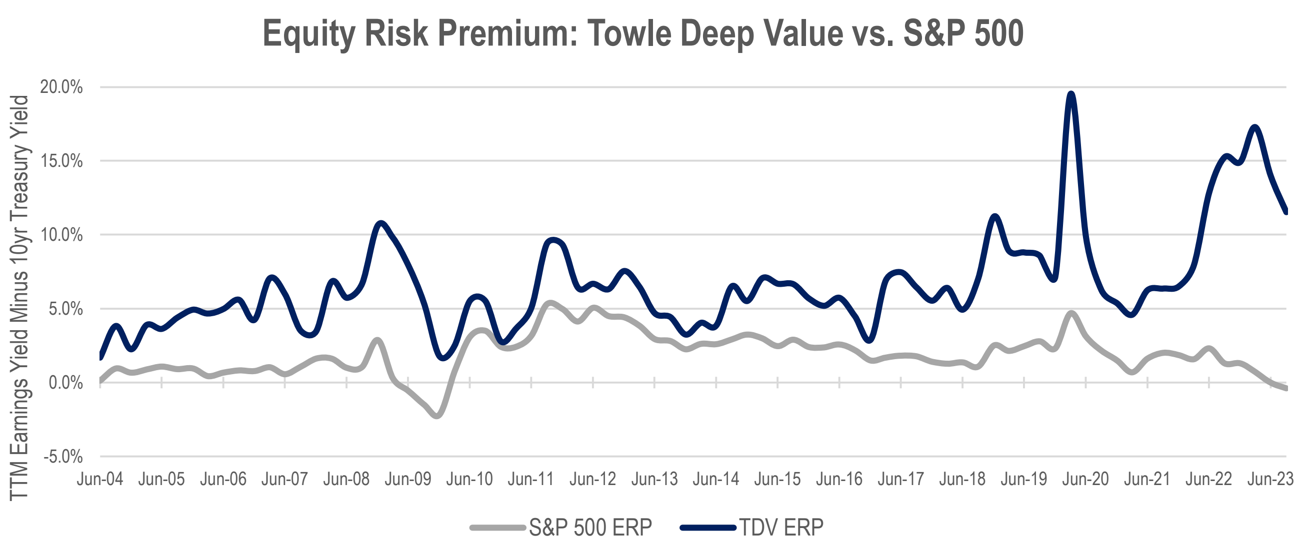


Source: S&P ClariFI, Towle & Co.

From 12/31/22 to 9/30/23, the S&P 500 is up 13.1%, the Russell 2000 Value is down -0.5%, and the Towle Deep Value Composite is up 1.2% net of fees.

One more. In our Q1 2023 commentary, we mentioned the equity risk premium (ERP) of the Towle portfolio compared to the S&P 500. Equity risk premium refers to the excess earnings yield available from equities compared to bonds. For example, if a $100 bond yields a $5 coupon (5% yield) and a $100 stock has earnings of $15 (15% yield), the equity risk premium is 10% (indicating a 10% higher yield vs. bonds to compensate for the additional risk of holding equities).

At the close of Q1 2023, our portfolio boasted a substantial 17% ERP, in stark contrast to the S&P 500's meager 1%. From 3/31/23 to 9/30/23, the Towle Deep Value Composite is up 0.5% net of fees, while the S&P 500 saw a 5.2% gain and the Russell 2000 Value inched up by 0.1%. As of this quarter-end, the S&P 500's trailing earnings yield stood at 4.2%, whereas the Towle portfolio commanded a robust 16.1%. When we deduct the 10-year Treasury yields, it unveils our ERP, as illustrated below. It's clear where we want our capital invested!



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

Astute observers may notice that the ERP on the S&P 500 is negative, meaning that U.S. Treasuries currently offer higher yields with lower risk. We think this reflects misplaced trust in the Magnificent 7 (Apple, Microsoft, Amazon, Alphabet, Tesla, Nvidia, and Meta), apprehension about the United States' ability to repay its debt, or both. It's worth noting that there's an appealing alternative: We believe *deep value* presents significantly higher appreciation potential than either the S&P 500 or U.S. Treasury securities.

The market's misplaced trust in "magnificent" stocks is a recurring bad habit. The 1993 book, *Sam Walton: Made in America,* detailed the same qualities that describe today's Magnificent 7. Throughout the '90s to its 1999 peak, Walmart's seemingly insurmountable scale, sustainable competitive advantages, and ability to perpetually grow and disrupt drove the stock price up 7x to a near 2.0x enterprise value / sales multiple. But can great businesses be bad stocks? Yes. For the next ~16 years WMT's stock price was flat. Great businesses can be bad stocks when priced for perfection. Will today's Magnificent 7 follow WMT's muted path forward?

There is one compelling reason why most of our personal capital is invested alongside yours: *valuation matters over the long term*. It's why we continually revisit these charts and why our track record demonstrates long-term outperformance. As the market eventually becomes a weighing machine, the Towle Deep Value portfolio stands ready!

Quarterly Review

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

Looking Ahead

As emphasized in the Investment Environment section, we believe the significant valuation gap between value and growth equities is unsustainable and will likely narrow. The rhythm of investment history underscores that such valuation disparities tend to mean revert over time. As investment styles ebb and flow, we remain dedicated to our investment process, confident that the tide will eventually turn.

Nevertheless, the recent underperformance of Towle Deep Value relative to growth stocks may lead investors to question its relevance when compared to the concentrated, tech-dominated equity indices. We firmly reject such an assertion. At its core, a reasonable return for any asset class should be based on earnings and/or cash flow in relation to the price paid. If investors are not currently optimizing this ratio, they are essentially betting on exceptionally high growth.

Near the peak of the 1999 Technology Bubble, renowned value investor John Neff illuminated the risks of high growth investing in his book, *John Neff on Investing*:

> "Forward growth rates are exposed to surprises. The market, to say the least, does not like to be negatively surprised. At high p/e levels, stocks' key support is from expectation encouraged by past performance, which is visible in their historical growth rates. With so much expectation built in, any hint of falling short can have punishing results…As many investors have learned the hard way, companies cannot double earnings each year ad infinitum. Just as the pendulum swings back toward the center, exceptional growth rates eventually descend toward the normal range. Experts use a fancy term to describe this process: reversion to the mean."

And fittingly, a look back at *our* January 2000 commentary showcases a historical rhyme with today's environment. In that commentary we stated:

> "In the dawn of the new millennium, we find ourselves astonished by the continued advance of technology-related issues at the expense of more value-oriented stocks…Impetuous investors willing to place bets on price momentum were the big winners…and those, like Towle & Co., who made decisions based on rational valuations were the laggards. It is a perplexing and historic time."

Two decades and three economic cycles later, we find ourselves in a similar situation. Back then, from 3/31/00 through 12/31/06, our net annualized return was 23% vs. 16% for the Russell 2000 Value and 0.8% for the S&P 500. Time will tell whether the pendulum swings again in our favor.

As legendary investor Sir John Templeton wisely noted, "the only way to execute under pressure is to have a deep-seated belief in your abilities and conviction that you are correct in your actions." Our longevity and track record demonstrate our ability. Our substantial personal investment in Towle Deep Value supports our conviction. With the inherent valuation risk in tech-heavy indices, we see our undervalued portfolio as a prudent investment choice in public markets.

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