Q3 | 2020

Income Equity

THE LONDON COMPANY

Market Observations & Portfolio Commentary

Quarterly Market Update

US stocks traded higher during the quarter driven by improving economic data, monetary and fiscal stimulus, and optimism around the eventual availability of vaccines and treatments to fight COVID-19. Stocks traded higher during July and August, but declined a bit in September. For the quarter, stocks posted gains across the market cap spectrum led by Large Caps. The Growth indexes continued their outperformance over the Value. Though Cyclical sectors outperformed Defensive in the Small Cap space, there was little difference among Large Caps. At the individual stock level, exposure to Growth, Volatility, Size, and Momentum factors had a positive impact on relative performance, while Value, Yield, and Quality had a negative impact.

Key Performance Takeaways for the Quarter

- The London Company Income Equity portfolio returned 9.7% gross (9.6% net) during the quarter vs. a 8.9% increase in the S&P 500. Relative outperformance was attributable to stock selection, partially offset by negative sector exposure, along with our minimal cash position.
- We are bottom-up stock pickers, but sector exposures influenced relative performance as follows:
  - *What Helped*: Overweight Industrials (a better performing sector) and Underweight Healthcare (a weaker performing sector)
  - *What Hurt*: Underweight Cons. Discretionary & Info. Technology (two better performing sectors)
- Greater participation by some of the more economically-sensitive sectors and less headwind from the mega-cap tech stocks benefitted our Income Equity strategy. In a period when large cap benchmark returns were strong but also punctuated by a September setback, we were pleased to have delivered good comparative results.

Top 3 Contributors to Relative Performance

- **United Parcel Service (UPS)** – UPS performed very well during Q3. UPS reported a very strong quarter, driven by strong e-commerce volumes, and the new CFO and CEO generated a lot of positive sentiment. UPS is also enacting surcharges to handle the rush of volumes and is getting prepared for a very strong peak season of demand around the holidays.
- **Target (TGT)** – TGT shares rallied in Q3 as same store sales were very strong. With its exclusives and differentiated products along with the introduction of drive-up and pick-up services, TGT continues to grow average ticket sales and drive traffic to its stores and website.
- **Lowes (LOW)** – Despite adjusted store hours due to COVID-19, LOW had a strong quarter. LOW's DIY and smaller Pro customers helped drive store traffic. LOW continues to execute on its transformational program and expense control plans.

Top 3 Detractors from Relative Performance

- **Cisco (CSCO)** – CSCO declined after announcing 2Q results that were better than feared, but lackluster guidance combined with the CFO's resignation, lack of buybacks (first time since 2003), and a restructuring plan raised concerns about management's strategic shift and execution abilities.
- **Intel (INTC)** – Despite reporting strong earnings, INTC fell after announcing a six month delay in moving to their 7nm manufacturing process node. Additionally, INTC announced a management restructuring and plans that it would be outsourcing some production to rival TSMC. Following the share price drop , INTC announced a large accelerated share repurchase, showing conviction at the lower price.
- **Chevron (CVX)** – CVX continued to struggle amid weak energy prices. CVX used its strong balance sheet and position of relative strength to buy Noble Energy (NBL) and has repeatedly stated that the dividend is a top priority. CVX has cut operating expenses and capital spending to protect cash flow.

Trades During the Quarter

- **Reduced: Apple (AAPL)** – Reduced on strength twice during Q3 reflecting the recent rally and large position size. We remain attracted to the fundamentals, but felt a smaller position was warranted given elevated valuation, now over 20x EV/EBITDA.
- **Increased: Johnson & Johnson (JNJ)** – Added to position twice during Q3. Additions reflect strength of JNJ's diverse business (three stable divisions), attractive valuation, a strong balance sheet is strong and solid operating margins.
- **Increased: Berkshire Hathaway (BRK.B)** – Added to BRK.B on weakness, reflecting its attractive valuation.
- **Increased: Verizon (VZ)** – Addition reflects the quality of VZ's wireless network and opportunity for long-term growth with 5G.
- **Initiated: Nintendo (NTDOY)** – NTDOY holds the leading position in the video game industry, with ~48% share. The video game industry is undergoing a digital transformation which is leading to higher margins and new revenue streams. We're drawn NTDOY's innovative hardware, valuable IP, strong fundamentals, and very healthy balance sheet—with ~22% of its market cap in cash equivalents. Further, we believe NTDOY possesses attractive downside protection via their 30+ years of timeless original IP content which can be further monetized.
- **Reduced: Fastenal (FAST)** –Trim reflects the recent strength of FAST and the resulting elevated valuation.
- **Exited: Wells Fargo (WFC)** – Exit reflects concerns about weaker earnings due to low interest rates and a flat yield curve along with weaker non-interest income.
- **Increased: Texas Instruments (TXN)** – Addition reflects the stability of TXN, growing dividend, and strong capital allocation.
- **Increased: Diageo (DEO)** – Addition reflects the strength of its stable brands and geographic diversity.

Looking Ahead

We are encouraged by the improvement in the economic data, but risks remain. In the near term, the US economy faces the dual risks of a possible spike in the virus potentially leading to delayed openings or business closings, and reduced unemployment benefits possibly limiting consumer income and consumer spending. In that environment, combined with relatively high valuations for stocks (20x P/E and 16x EV/EBITDA), we expect significant share price volatility. Longer term, we remain optimistic about the prospects for the economy. While we believe the risks and rewards are somewhat balanced as they relate to stocks overall, we always remain cautious and focus on limiting downside in each holding.

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Performance

As of September 30, 2020

			Annualized				
Composite	QTD	YTD	One Year	Three Years	Five Years	Ten Years	Inception to Date
Gross	**9.7**	**0.9**	**9.1**	**10.3**	**11.2**	**13.1**	**9.1**
Net	**9.6**	**0.6**	**8.7**	**9.8**	**10.8**	**12.5**	**8.4**
S&P 500	8.9	5.6	15.2	12.3	14.2	13.7	6.1

Inception Date: 12/31/1999

The Income Equity product is typically compared to the Russell 1000 Value. Any comparison to the S&P 500 is for illustrative purposes only. All are encouraged to read and understand the disclosure notes found below.

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Disclosure notes

The London Company's performances are size weighted and annualized based on calculations for the period ending September 30, 2020. The characteristics discussed herein relate to a representative account, and not every client's account will have these exact characteristics. As London manages its client portfolios according to each client's specific investment needs and circumstances, London cannot affirm that the characteristics of the account shown are similar to all accounts participating in the strategy. This is due in part to the timing of trades by the Adviser, market conditions, cash availability, and the timing of client deposits and withdrawals. Therefore, prospective clients should not assume that similar performance results to those shown would have been achieved for their accounts had they been invested in the strategy during the period. None of the information contained herein should be construed as an offer to buy or sell securities, or as investment recommendations. An investment in a London Company strategy is subject to risks, including the loss of principal.

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Composite Creation/
Inception Date: December 31,1999

Composite Definition: The Income Equity strategy invests mainly in common equities with a focus on higher overall dividend yield orientation, which may be supplemented with primarily investment grade, preferred equities. This strategy has a more conservative orientation, with a focus on capital preservation, income and growth, in order to provide greater yield and downside protection relative to our Large and Mid Cap strategies. Our Income Equity strategy is designed to generate above-average, absolute returns over full market cycles. Accounts in this product composite are fully discretionary taxable and tax-exempt portfolios with no minimum dollar amount of assets. The product is measured against the Russell 1000 Value Index and has a creation and inception date of December 31, 1999. There is no use of leverage, derivatives or short positions. All actual fee-paying discretionary portfolios are included in one or more composites that have been managed for a full calendar quarter with limited restrictions and similar objectives. Composite may include accounts under dual contract.

Benchmark Description: The Russell 1000 Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 Index companies with lower price-to-book ratios and lower expected growth values. Benchmark returns are not covered by the report of independent verifiers.

Performance and Fees: Gross of fee returns are calculated gross of management and custodian fees and net of transaction costs. Net of fee returns are calculated net of actual management fees and transaction costs and gross of custodian and other fees. Returns may be net of miscellaneous fund expenses. The gross figures do not reflect the deduction of investment advisory fees. For example, an account that earned 15% per year for 10 years would have an accumulated return of 305% before fees and 270% after fees, assuming a 1% fee. Returns are calculated and stated in US dollars. Returns are calculated gross of withholding taxes on foreign dividends and interest. Dividends are reinvested. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.

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