Q1 | 2022

Mid Cap

THE LONDON COMPANY

Market Observations & Portfolio Commentary

Quarterly Market Update

US equities traded lower during Q1 reflecting concerns about higher inflation, a clear shift toward tighter monetary policy, and the war in Ukraine. Economic data released during Q1 were generally positive; however, there are increasing signs of decelerating growth as high inflation is limiting purchasing power. The Federal Reserve increased the fed funds rate and plans to begin tapering its balance sheet; moreover, it is expected to be more aggressive with monetary policy, given elevated inflation and low unemployment. All of the major indexes traded lower, but Large Cap held up the best. The Value indexes significantly outperformed the Growth across the market cap spectrum. In general, cyclical shares outperformed the more defensive. Turning to factors that drove performance, Value, Yield, and Momentum had a positive influence on relative returns. Growth and Quality had a mixed impact, and Volatility factors had a negative impact.

Key Performance Takeaways for the Quarter

- The London Company Mid Cap portfolio declined -7.9% gross (-7.9% net) during the quarter vs. a -5.7% decrease in the Russell Midcap Index. Both sector exposure and stock selection were headwinds to relative performance.
- We are bottom-up stock pickers, but sector exposures influenced relative performance as follows:
  - *What Helped*: Overweight Cons. Staples & Materials (two better performing sectors)
  - *What Hurt*: Underweight Energy & Utilities (the best performing sectors)
- The Mid Cap portfolio lagged our expectations during Q1'22. No exposure to the Energy sector was the primary driver of the underperformance, but limited exposure to deep value holdings and a handful of individual stocks also contributed to the underperformance. While some of the stocks were down over the short period, we believe the fundamentals of the businesses are in good shape, and those companies should compound high returns on capital in the years ahead. If the market downturn were to extend beyond a quarter, we believe investors will focus more on higher quality factors like return on capital, consistency of cash flow, and balance sheet flexibility.

Top 3 Contributors to Relative Performance

- **Cincinnati Financial (CINF)** – CINF, along with other insurance companies, received a significant boost from pricing gains as insurers were able to price ahead of inflation. Separately, higher interest rates can lead to greater income from their bond investments, which are typically held to maturity. Moreover, CINF reported another solid quarter, which included significant reserve releases and pricing gains.
- **Alleghany (Y)** – During Q1, Y announced that it will be acquired by Berkshire Hathaway in an all cash deal valuing Y at roughly $11.6B or $848 per share. The deal is expected to close in Q4. Y rallied over 25% after the announcement of the deal.
- **Dollar Tree (DLTR) –** DLTR outperformed in Q1 given activist investor Mantle Ridge's successful efforts to reform management and governance. Mantle Ridge appointed Rick Dreiling as Executive Chairman. Rick previously led the turnaround at Dollar General, and will work with DLTR executives over the next 5 years to reform Family Dollar and successfully implement the $1.25 price point at Dollar Tree.

Top 3 Detractors from Relative Performance

- **CarMax (KMX)** – After outperforming in 2021, KMX underperformed during Q1 due to concerns around the used car market, normalized average selling prices, and higher interest rates. KMX reported record sales, but experienced limited operating leverage as it passed savings to customers and focused on market share growth. The wholesale and financing businesses are performing strong. Management is focused on growing profitable market share in multiple channels by utilizing its omni platform and existing infrastructure. KMX continues to disrupt the used car ecosystem and we maintain our conviction in the stock.
- **Black Knight (BKI)** – Concerns about rising mortgage rates and the potential impact on housing negatively impacted BKI. Most of BKI's revenue comes from servicing current mortgages, not originations, but rate fears can still impact the stock in the near term. BKI also purchased additional shares in a company called Optimal Blue. The move may have suggested a conflict of interest on the part of Bill Foley, who holds considerable sway over both sides of the transaction. We still like the stickiness of BKI's revenues as well as their growth prospects.
- **Armstrong World Industries (AWI)** – AWI's Q1 weakness stems from a perceived slower recovery in domestic industrial and construction activity. However, AWI held an Analyst Day that outlined higher expectations for free cash flow growth over the long-term. AWI's leading market position in the highly consolidated ceiling tiles business gives them a sticky and large installed base with pricing power.

Trades During the Quarter

- **Spin-off: BellRing (BRBR)** – In late March, Post Holdings spun off shares of BRBR to shareholders. BRBR is primarily made up of its Premier Protein shake brand, a leader in the fast growing protein shake category. In addition, this business includes its Dymatize (protein powders) and PowerBar (nutritious snack bars) brands. BRBR is now roughly 1% of the Mid Cap portfolio.

Looking Ahead

We expect greater volatility driven by higher than normal inflation, a more aggressive shift in monetary policy, and the war in Ukraine. Despite the many risks to the near term outlook, we believe there are reasons for optimism as well. Economic data is generally positive with solid corporate earnings, rising GDP, as well as low unemployment and higher wages for consumers. Separately, as the effects of COVID continue to fade, we could experience faster than expected global supply chain improvements, which could lead to lower inflation. Monetary policy will likely remain in focus. The big question is can the Fed get inflation expectations under control without causing a recession. We recognize the difficulty in navigating a soft landing, so the odds of a recession over the next couple of years have increased. That is the message we take from the recent inversion of the yield curve. In terms of the equity market, we note that multiple compression is likely given rising interest rates and higher than normal inflation. We expect greater volatility and possibly more muted returns relative to the strong returns generated from 2009-2021. Longer term, we continue to believe that quality attributes and solid company fundamentals will lead to strong risk adjusted returns over time.

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Performance

As of March 31, 2022

	QTD	One Year	Three Years	Five Years	Inception to Date
Mid Cap (Gross)	-7.9	1.0	12.8	13.5	13.5
Mid Cap (Net)	-7.9	0.7	12.4	13.1	13.0
Russell Mid Cap	-5.7	6.9	14.9	12.6	12.9

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Disclosure notes

The London Company's performances are size weighted and annualized based on calculations for the period ending March 31, 2022. 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: March 31, 2012

Composite Definition: The Mid Cap equity strategy invests mainly in conservative, low-beta mid cap equities with a focus on above-average downside protection. Primarily, we seek profitable, financially stable mid cap companies that consistently generate free cash flow, high returns on unleveraged operating capital, trade at significant discounts to their intrinsic values, and are run by shareholder-oriented management. Positions are usually within the market capitalization range of the major, domestic mid cap indices. Accounts in this product composite are fully discretionary taxable and tax-exempt portfolios with a minimum of $100,000 in assets. This product is measured against the Russell Mid Cap Index and has a creation and inception date of March 31, 2012. 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: Primary: Russell Midcap Index measures the performance of the mid-cap segment of the U.S. equity universe. The Russell Midcap is a subset of the Russell 1000 Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership. Secondary: Russell Midcap Value Index measures the performance of the mid-cap segment of the U.S. equity universe. It includes those Russell Midcap Index companies with lower price-to-book ratios and lower forecasted 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 investments, calculating performance, and preparing GIPS Reports are available upon request.

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