Q3 | 2020

Small Cap

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 Small Cap portfolio returned 5.1% gross (4.9% net) during the quarter vs. a 2.6% increase in the Russell 2000 Value Index. Outperformance was driven by sector exposure, partially offset by stock selection and our allocation to cash.
- We are bottom-up stock pickers, but sector exposures influenced relative performance as follows:
  - *What Helped*: Overweight Cons. Discretionary (the best performing sectors) and underweight Financials (a weaker performing sector)
  - *What Hurt*: Overweight Real Estate (a weaker performing sector) and underweight Healthcare (a better performing sector)
- For the quarter, absolute and relative performance were quite good. Given the market's tilt towards growth and the strength of highly leveraged, loss making companies with bottom quintile Returns on Invested Capital, we were quite pleased with the Small Cap strategy's outperformance, despite these headwinds to our higher quality portfolio.

Top 3 Contributors to Relative Performance

- **Tempur-Sealy (TPX)** – TPX reported strong topline growth for 2Q with sales rebounding much faster than anticipated. Management indicated the positive demand trends should continue into year-end. While other competitors are suffering from supply constraints, TPX's higher margin brand is mostly insulated from these issues, performing well and taking share.
- **Churchill Downs (CHDN)** – 2020 has been an anomalous year for CHDN. The Kentucky Derby was held later than usual and without fans, and CHDN's casinos were temporarily shut down earlier in the year. However, the stock has performed well on strong performance from its online betting platform as well as industry-wide optimism around iGaming and sports betting.
- **Masonite International (DOOR)** – DOOR's outperformance was mainly due to the positive impact of the pricing actions that took effect earlier in 2020. Those price hikes turned a double-digit decline in sales (weak volume) into a double-digit percentage jump in EBITDA. The stock rallied further as its only competitor followed along with its own price hikes.

Top 3 Detractors from Relative Performance

- **NewMarket (NEU) –** Despite a rebound in the economy, NEU declined during Q3 due to its nearly 100% exposure to the automotive industry and miles driven by vehicles. 2Q20 earnings were weaker than expected, as the drop in global transportation greatly affected NEU's product consumption.
- **White Mountains (WTM)** – WTM has had undeployed capital of ~30% of its market capitalization, which is primarily why it has not participated as fully in the broader market rebound. Fortunately, WTM recently announced that it has deployed the remainder of its capital with an investment in a Bermuda-based re/insurer in October to capitalize on rising premiums.
- **Armstrong World Industries (AWI)** – AWI struggled after reporting a rough 2Q20, as mandatory shutdowns in their top 7 markets disproportionately hurt sales and margins. As a result, management issued second half guidance below consensus.

Trades During the Quarter

- **Reduced: Entegris (ENTG)** – Trimmed twice in Q3 reflecting ENTG's significant outperformance to the broader market. ENTG' market cap now exceeds $9B, which is too large for the Small Cap portfolio, so we'll continue to slowly move out of it.
- **Reduced: GATX (GATX)** – Trim reflects competition in the railcar space along with the oversupply, which could lead to weaker revenue and margins in the future. This could elevate the risk posed by GATX's relatively high debt levels.
- **Initiated: Cannae Holdings (CNNE)** – CNNE is a holding company with two main assets (shares in Ceridian [CDAY] and Dun & Bradstreet [DNB]), as well as other investments. It is led by Bill Foley, who has an excellent track record of creating shareholder value over time. CDAY is a human resources/payroll outsourcing firm, and it is mostly a passive equity for CNNE today that they are actively monetizing. DNB is a unique asset with data on 360mm companies, that is a vital source of information needed by creditors and sales divisions. We're attracted to the restructuring of the business and significant reinvestment opportunities. We believe CNNE trades at a compelling discount to its sum-of-the-parts intrinsic value. The early progress and subsequent IPO of D&B is encouraging. Further conviction comes from significant insider purchases.
- **Exited: MBIA (MBI)** – Reflects lingering concerns over various municipalities with financial issues, including Puerto Rico.
- **Initiated: ACI Worldwide (ACIW)** – ACIW is a payment systems company that develops a broad line of software focused on facilitating real-time electronic payments. ACIW's longer term contracts and blue-chip client base result in a recurring revenue stream and stable cash flow generation. We believe revenue, margins, and ROIC should improve over time as ACIW benefits from new management initiatives to accelerate growth, supported by the secular tailwind towards the digitization of payments and the use of real-time payments.

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 business closings, and reduced unemployment benefits possibly limiting consumer income and spending. In that environment, combined with relatively high valuations for stocks, we expect significant share price volatility. Longer term, we remain optimistic about the prospects for the economy. While we believe the risks and rewards with stocks are somewhat balanced overall, we always remain cautious and focus on limiting downside in each holding.

Past performance should not be taken as a guarantee of future results.

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Performance

As of September 30, 2020

Composite	QTD	YTD	Annualized: One Year	Annualized: Three Years	Annualized: Five Years	Annualized: Ten Years	Annualized: Inception to Date
Gross	**5.1**	**-11.4**	**-7.1**	**2.4**	**4.6**	**8.8**	**11.7**
Net	**4.9**	**-11.9**	**-7.8**	**1.6**	**3.8**	**8.0**	**11.2**
Russell 2000 Value	2.6	-21.5	-14.9	-5.1	4.1	7.1	7.8

Inception Date: 9/30/1999

The Small Cap product is typically compared to the Russell 2000. Any comparison to the Russell 2000 Value 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: September 30, 1999

Composite Definition: The Small Cap strategy invests mainly in conservative, low-beta small cap equities with a focus on above-average downside protection. Primarily we seek profitable, financially stable small 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 small cap indices. Accounts in this product composite are fully discretionary taxable and tax-exempt portfolios with a minimum of $100,000 in assets. The product is measured against the Russell 2000 Index and has a creation and inception date of September 30, 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: Primary: Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe. Russell 2000 is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership. Secondary: Russell 2000 Value Index measures the performance of small-cap segment of the U.S. equity universe. It includes those Russell 2000 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 portfolios, calculating performance, and preparing compliant presentations are available upon request.

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