THE LONDON COMPANY

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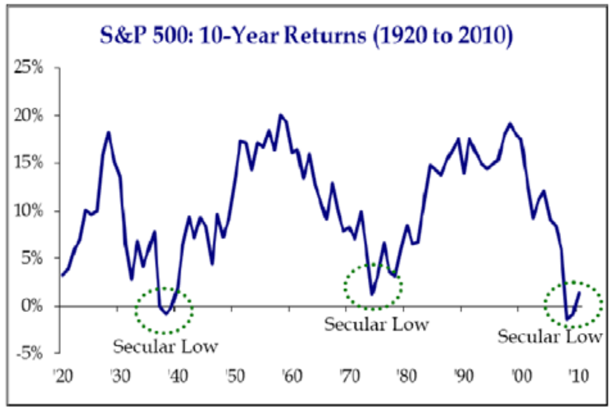
Dear Client,

The market withstood a few heavy punches this quarter and is still standing tall. Its resiliency has been quite impressive as it has successfully brushed off a number of unexpected, *Black Swan* type events. From political revolts in North Africa and the Middle East which led to higher oil prices, to earthquakes and tsunamis in Japan which led to fears of nuclear radiation, to global food inflation which, among many things, is leading to a slowing China, the domestic equity markets weathered these tests and gradually marched higher. It is hard to speculate how markets will react to any event, but it's at least reassuring that these isolated instances haven't derailed an improving investor disposition. Sentiment is slowly increasing and, as a result, the appetite for equities is growing. Nevertheless, it is worth noting that this enthusiasm is evolving from the depths of despair towards stocks and still has a long way to go.

The S&P 500 returned 5.9% for the quarter and the Russell 2000 did slightly better with a 7.9% gain. Like last quarter, the Energy sector led returns. Unlike last quarter, this sector was relatively alone in its outperformance. As a reminder, in our communication with you last time we went into detail about return correlation, and how since 2009 beta drove returns at the expense of fundamentals. The correlation of equities, or percentage of stocks moving in the same direction, was near a fifty-year high and two standard deviations above the long-term mean. While beta still led returns this quarter, we did see some reversion of that trend regarding sector dispersion. Energy was by far the biggest beneficiary, as that sector led both the large and small cap benchmarks with a gain of 17% in the S&P 500 and 20% in the Russell 2000. A lack of exposure to this sector would have made outperformance nearly impossible. Despite having minimal direct exposure to the price of the commodity itself, our Energy holdings performed well enough to neutralize the rapid rise in oil prices.

Information Technology was similar in small cap, as returns of these stocks significantly outpaced the overall index. Our exposure in small cap has historically been less than the benchmark and this hurt performance. And to make matters worse, the portfolio holdings we do own did poorly in their own regard. In fact, more than 100% of our underperformance in small cap this quarter came from our underweight and selection in Technology. Information Technology is a difficult space for our style in small cap. Most companies have product cycles much shorter than our time horizon and the ones that meet our criteria commonly trade at excessive valuations. We believe the names we do own are undervalued and should perform well over time. This quarter was just not their moment to shine.

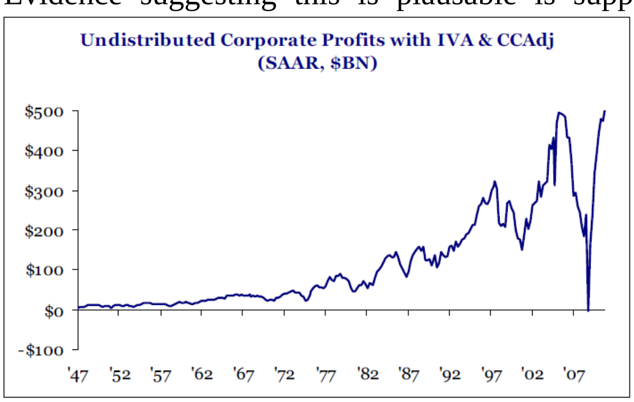
Looking ahead, we remain confident that equities are attractive compared to other asset classes. One of the most compelling arguments supporting this thesis is simply where we are now versus where we've come from. With a starting point of today, we are at a historically attractive entry point as indicated by the chart to the right. Despite an impressive run from the March 2009 low, the market returns over the last decade have been abysmal. The next decade should yield much more rewarding returns for long-term investors. This does not mean the path will be smooth. In fact, near-term volatility is almost certain as a number of variables play out.



Source: Strategas

One of the largest variables is the actions of the Federal Reserve, whose benevolence has acted as a tailwind for the equity markets. The willingness to stimulate the economy through easy monetary policy, particularly the ongoing second round of quantitative easing, has unquestionably helped stock prices. The correlation of the S&P 500 and the direction of the Fed's balance sheet is 86% over the last two years. These actions have had a positive effect but do come with consequences, specifically future inflation. The Fed operates with a dual mandate to maintain low unemployment and stable inflation. Thus, the Fed is cast with an almost impossible task of tightening monetary policy at the right moment - when the employment picture is on sound footing but before inflation sets in. The timing of interest rate hikes has investors and even members within the Fed debating when the practice of easy money should end. Market multiples are already discounting a rise in rates, so it has become a matter of when and not if there is a policy change. Regardless, the clock is ticking closer to that day of reckoning when the economy (and the equity markets) will have to support themselves.

Evidence suggesting this is plausable is supported by the fact that U.S. GDP and corporate profits have reached new nominal highs. As indicated in the chart to the left, the level of undistributed corporate profits has risen quickly in the last two years. The strength of corporate margins and the ability to drive increased operating leverage is pushing equity prices higher. Yet, the ability of companies to generate such earnings growth without the offsetting capital outlays



Source: Strategas

cannot continue forever. Management teams are now sitting on $1.4 trillion in cash and will need to invest the assets on the balance sheet earning next to nothing. The need for corporations to hire again will absorb some of the current excess profit margin, but provide job creation and support for the economic recovery.

We expect this excess cash to be invested and act as a support for the market even if the Fed steps to the sidelines. For example, capital expenditures and returning cash to shareholders through dividends and buybacks will continue to grow. We are seeing increasing dividend payouts and share repurchases and we expect these actions to support valuations in the near term. Most notably was the first announced dividend from Cisco, often the Technology poster child of hoarding cash at the expense of shareholders. Moreover, the desire of companies to acquire growth remains strong. While organic growth remains challenged, corporations are still seeking M&A deals to enhance revenue. Although the actual number of deals declined this quarter to 91 from 116 last year, the size of the deals increased to $8.9 billion from $7.4 billion a year ago. The largest being the recent $40 billion offer from AT&T to T-Mobile. The availability of credit to complete larger deals is another sign that the economy is moving in the right direction.

Our investment approach has historically done well in an acquisitive market. Companies with high returns on capital, stable and recurring cash flows, and low debt are also attractive to private equity and larger competitors. We are encouraged that many of our holdings still trade at significant discounts to what private market values are indicating.
We believe our process is a competitive advantage in this environment and our ability to unearth value will be rewarded. Given reasonable valuations, strong corporate profits, and an underinvested public, we are optimistic about the risk/reward profile for long-term equity investors.

Thank you for your continued confidence and trust. Please feel free to call with questions.

Best regards,

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