

# THE LONDON COMPANY

GODDARD CAPITAL MANAGEMENT  
INVESTMENT COUNSEL

Stephen M. Goddard, CFA  
Managing Director

One James Center, Suite 1501  
Richmond, Virginia 23219

Telephone: 804-775-0317  
Facsimile: 804-649-9447

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The S&P 500 was up 1.4% for the second quarter of 2005. In the quarter, the market was led by the home building, technology, and real estate sectors. Even though the market was up this quarter, it was still down 1.7%, ex-dividends, for the year.

We continue to be cautiously optimistic about the market and the economy. More importantly, we believe our strategy of investing in high quality, stable companies at reasonable valuations, with the potential to increase dividends, will outperform the broader averages over the next several years.

As we have mentioned in the past, one of the remarkable things about the current period is that corporate America is in its best financial shape ever. Corporations are flushed with cash, have low or no debt, and are generating record-breaking free cash flow. For the most part, companies are overcapitalized and underlevered, which is in contrast to most consumers.

This underlevering of corporate America matters, and numerous studies have shown that return on equity (ROE) is one of the major determinants of outperformance. That is, companies with a higher ROE are rewarded in the stock market with higher valuations.

Companies can easily increase their ROE by leveraging their balance sheet, assuming their return on assets is higher than their cost of capital, which is the case for all the companies in our portfolios. In our mind, they can do this in one of four ways: (1) take on more debt; (2) invest in more property, plant, and equipment (i.e., grow their businesses); (3) make intelligent acquisitions; or (4) reduce their equity through returning cash to shareholders. The first two are less likely than the latter two, in our opinion.

Although taking on debt will increase ROE, we suspect that the market will not take kindly to it, unless the company has a specific use for the capital. Investing in more property, plant, and equipment would potentially generate more capital than what is already considered "surplus" capital. In addition, there is still excess capacity in many industries, so increasing capacity could potentially damage a company's ROE.

Either of the latter two options (mergers and acquisitions, or return the excess capital to shareholders through dividends or share buybacks) could contribute significantly to your portfolio, if the environment unfolds as we believe it will. In the case of mergers and acquisitions, we believe we have bought all the companies in your portfolio at attractive valuations. Hence, should these companies be subject to acquisitions, there should be a

nice gain within your portfolio. In the second case, we are more biased towards dividends as opposed to share repurchases, as growth is moderating.

We believe dividends are a more equitable way of returning excess capital to shareholders as they are becoming valued more than retained earnings. As we have stated in the past, there are many other reasons why we believe dividend-paying stocks will outperform non-dividend paying stocks. Numerous studies have shown that managers of companies who pay dividends are, for the most part, better allocators of capital.

We believe that the coming decade will see dividends return to contributing to approximately 40% of the total return from equities. Companies with high dividend growth will outperform their stagnant counterparts.

To summarize, we have an environment where long-term rates are low; corporations are in excellent financial shape and have an incentive to increase their leverage; corporate payout ratios are low; and the spread between 10-year Treasury yields and dividend yields are the lowest they have been since the 60's. In our opinion, owning high quality companies (that could pay increasing dividends) in this environment is a better choice than owning Treasury bonds. All of these factors point to what we see as increasing demand for dividend-paying stocks, which is why we are cautiously optimistic about the future.

However, we do see some clouds on the horizon — most notably, an overextended consumer. Cash-out refinancings do not work well when interest rates are not falling. The Federal Reserve is determined to prevent inflation and can hopefully slow down the real estate market. We believe the Fed will most likely finish its course of rate hikes this year, and stocks will start to anticipate this as we get closer to year-end.

Higher energy prices are somewhat concerning as well, although we are inclined to believe that we can cope with a rise in energy prices as long as it happens gradually. However, there is no escaping the fact that higher oil prices are inflationary.

Even though we believe higher energy prices are here to stay and while the Fed continues to raise short-term rates, we believe long-term rates will not trend significantly higher at this time. The globalization of trade and the glut of foreign capital (namely from China, India, and the rest of the developing world) have a greater deflationary effect, in our opinion. So, corporate America is in a bit of a bind: it is unable to significantly raise prices, yet some costs continue to increase. It must respond by increasing productivity. This brings us back to our outlook of a somewhat subdued profit growth and equity market returns over the next decade in the mid-single digit range for the broad market. In our opinion, this all points to the increasing importance of dividends in equity returns.

We continue to look for companies that meet our investment criteria of having high cash returns on operating capital, shareholder-oriented corporate governance, and valuations that we find attractive. We have become selectively more optimistic on the technology and healthcare sectors, and have increased our weightings accordingly.

Enclosed with your portfolio statement this month, per SEC requirements, are copies of our current "Client Privacy Notice" and "Proxy and Corporate Action Voting

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Policies and Procedures”. Please advise in writing if you would like to receive a current copy of our Form ADV Part II.

As always, we thank you for your continued confidence and should you have any questions/comments, please feel free to contact us.

Best regards,

A handwritten signature in black ink, appearing to read "Stephen M. Goddard".

Stephen M. Goddard, CFA

SMG:mwm

Enclosures: Client Privacy Notice  
Proxy and Corporate Action Voting Policies and Procedures

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## Client Privacy Notice

Our Client Privacy Notice tells you the kind of information we collect about you, with whom we share it, and how we protect it responsibly. The Notice applies to both current and past clients of our firm. We use the term “client” as the equivalent of the SEC’s term “customer”. We provide a current Client Privacy Notice to all active clients annually.

### Categories of Information We Collect

We collect non-public personal information about you from the following sources:

1. Information we receive from you on brokerage applications, our investment profile, and other forms or oral discussions, which could include your name, address, social security number, assets and income;
2. Information about your transactions with us or others; and
3. Information about your investment holdings from financial and other statements you provide us.

We do not collect any information about you from third party consumer reports.

### Disclosure of Information to Third Parties

We do not disclose any non-public personal information about our clients or former clients to anyone, except as permitted by law.

If you terminate our relationship with us, we will continue to treat information we have collected about you in accordance with this Notice.

### Our Security Procedures

We restrict access to non-public personal information about you to those employees of The London Company who need to know that information to enable us to serve you. We maintain physical, electronic, and procedural safeguards that comply with federal standards to guard your non-public personal information. The London Company’s employees are all bound by its policy to keep all non-public personal information confidential to the firm.

Should we dispose of any non-public personal information, we will take appropriate measures to protect against unauthorized access to or use of the information in connection with its disposal.

### Summary

We are dedicated to protecting your privacy and your non-public personal information. If you have any questions or concerns in this regard, please do not hesitate to contact us at 804-775-0317.

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## Proxy and Corporate Action Voting Policies and Procedures

### I. POLICY

The London Company of Virginia (the “Adviser”) acts as discretionary investment adviser for various clients, including clients governed by the Employee Retirement Income Security Act of 1974 (“ERISA”) and registered open-end investment companies (“mutual funds”). The Adviser’s authority to vote proxies or act with respect to other shareholder actions is established through the delegation of discretionary authority under its investment advisory contracts. Therefore, unless a client (including a “named fiduciary” under ERISA) specifically reserves the right, in writing, to vote its own proxies or to take shareholder action with respect to other corporate actions requiring shareholder actions, the Adviser will vote all proxies and act on all other actions in a timely manner as part of its full discretionary authority over client assets in accordance with these Policies and Procedures. Corporate actions may include, for example and without limitation, tender offers or exchanges, bankruptcy proceedings, and class actions.

When voting proxies or acting with respect to corporate actions for clients, the Adviser’s utmost concern is that all decisions be made solely in the best interest of the client (and for ERISA accounts, plan beneficiaries and participants, in accordance with the letter and spirit of ERISA). The Adviser will act in a prudent and diligent manner intended to enhance the economic value of the assets of the client’s account.

### II. PURPOSE

The purpose of these Policies and Procedures is to memorialize the procedures and policies adopted by the Adviser to enable it to comply with its fiduciary responsibilities to clients and the requirements of Rule 206(4)-6 under the Investment Advisers Act of 1940, as amended (“Advisers Act”). These Policies and Procedures also reflect the fiduciary standards and responsibilities set forth by the Department of Labor for ERISA accounts.

### III. PROCEDURES

The Advisor is ultimately responsible for ensuring that all proxies received by the Adviser are voted in a timely manner and in a manner consistent with the Adviser’s determination of the client’s best interests. Although many proxy proposals can be voted in accordance with the Adviser’s established guidelines (see Section V. “Guidelines” below), the Adviser recognizes that some proposals require special consideration which may dictate that the Adviser makes an exception to the Guidelines.

The Advisor is also responsible for ensuring that all corporate action notices or requests which require shareholder action received by the Adviser are addressed in a timely manner and consistent action is taken across all similarly situated client accounts.

#### A. Conflicts of Interest

Where a proxy proposal raises a material conflict between the Adviser’s interests and a client’s interest, including a mutual fund client, the Adviser will resolve such a conflict in the manner described below:

1. **Vote in Accordance with the Guidelines.** To the extent that the Adviser has little or no discretion to deviate from the Guidelines with respect to the proposal in question, the Adviser shall vote in accordance with such pre-determined voting policy.

2. **Obtain Consent of Clients.** To the extent that the Adviser has discretion to deviate from the Guidelines with respect to the proposal in question, the Adviser will disclose the conflict to the relevant clients and obtain their consent to the proposed vote prior to voting the securities. The disclosure to the client will include sufficient detail regarding the matter to be voted on and the nature of the Adviser's conflict that the client would be able to make an informed decision regarding the vote. If a client does not respond to such a conflict disclosure request or denies the request, the Adviser will abstain from voting the securities held by that client's account.
3. **Client Directive to Use an Independent Third Party.** Alternatively, a client may, in writing, specifically direct the Adviser to forward all proxy matters in which the Adviser has a conflict of interest regarding the client's securities to an identified independent third party for review and recommendation. Where such independent third party's recommendations are received on a timely basis, the Adviser will vote all such proxies in accordance with such third party's recommendation. If the third party's recommendations are not timely received, the Adviser will abstain from voting the securities held by that client's account.

The Advisor will review the proxy proposal for conflicts of interest as part of the overall vote review process. All material conflict of interest so identified by the Adviser will be addressed as described above in this Section III.A.

#### B. Limitations

In certain circumstances, in accordance with a client's investment advisory contract (or other written directive) or where the Adviser has determined that it is in the client's best interest, the Adviser will not vote proxies received. The following are certain circumstances where the Adviser will limit its role in voting proxies:

1. **Client Maintains Proxy Voting Authority:** Where client specifies in writing that it will maintain the authority to vote proxies itself or that it has delegated the right to vote proxies to a third party, the Adviser will not vote the securities and will direct the relevant custodian to send the proxy material directly to the client. If any proxy material is received by the Adviser, it will promptly be forwarded to the client or specified third party.
2. **Terminated Account:** Once a client account has been terminated with the Adviser in accordance with its investment advisory agreement, the Adviser will not vote any proxies received after the termination. However, the client may specify in writing that proxies should be directed to the client (or a specified third party) for action.
3. **Limited Value:** If the Adviser determines that the value of a client's economic interest or the value of the portfolio holding is indeterminable or insignificant, the Adviser may abstain from voting a client's proxies. The Adviser also will not vote proxies received for securities which are no longer held by the client's account. In addition, the Adviser generally will not vote securities where the economic value of the securities in the client account is less than \$500.
4. **Securities Lending Programs:** When securities are out on loan, they are transferred into the borrower's name and are voted by the borrower, in its discretion. However, where the Adviser determines that a proxy vote (or other shareholder action) is materially important to the client's account, the Adviser may recall the security for purposes of voting.
5. **Unjustifiable Costs:** In certain circumstances, after doing a cost-benefit analysis, the Adviser may abstain from voting where the cost of voting a client's proxy would exceed any anticipated benefits to the client of the proxy proposal.

#### IV. RECORDKEEPING

In accordance with Rule 204-2 under the Advisers Act, the Adviser will maintain for the time periods set forth in the Rule (i) these proxy voting procedures and policies, and all amendments thereto; (ii) all proxy statements received regarding client securities (provided however, that the Adviser may rely on the proxy statement filed on EDGAR as its records); (iii) a record of all votes cast on behalf of clients; (iv) records of all client requests for proxy voting information; (v) any documents prepared by the Adviser that were material to making a decision how to vote or that memorialized the basis for the decision; and (vi) all records relating to requests made to clients regarding conflicts of interest in voting the proxy.

The Adviser will describe in its Part II of Form ADV (or other brochure fulfilling the requirement of Rule 204-3) its proxy voting policies and procedures and will inform clients how they may obtain information on how the Adviser voted proxies with respect to the clients' portfolio securities. Clients may obtain information on how their securities were voted or a copy of the Adviser's Policies and Procedures by written request addressed to the Adviser. The Adviser will coordinate with all mutual fund clients to assist in the provision of all information required to be filed by such mutual funds on Form N-PX.

## V. GUIDELINES

Each proxy issue will be considered individually. The following guidelines are a partial list to be used in voting proposals contained in the proxy statements, but will not be used as rigid rules.

### A. Oppose

The Adviser will generally vote against any management proposal that clearly has the effect of restricting the ability of shareholders to realize the full potential value of their investment. Proposals in this category would include:

1. Issues regarding the issuer's Board entrenchment and anti-takeover measures such as the following:
  - a. Proposals to stagger board members' terms;
  - b. Proposals to limit the ability of shareholders to call special meetings;
  - c. Proposals to require super majority votes;
  - d. Proposals requesting excessive increases in authorized common or preferred shares where management provides no explanation for the use or need of these additional shares;
  - e. Proposals regarding "fair price" provisions;
  - f. Proposals regarding "poison pill" provisions; and
  - g. Permitting "green mail".
2. Providing cumulative voting rights.

### B. Approve

Routine proposals are those which do not change the structure, bylaws, or operations of the corporation to the detriment of the shareholders. Given the routine nature of these proposals, proxies will nearly always be voted with management. Traditionally, these issues include:

1. Election of auditors recommended by management, unless seeking to replace if there exists a dispute over policies.
2. Date and place of annual meeting.
3. Limitation on charitable contributions or fees paid to lawyers.
4. Ratification of directors' actions on routine matters since previous annual meeting.
5. Confidential voting.

Confidential voting is most often proposed by shareholders as a means of eliminating undue management pressure in shareholders regarding their vote on proxy issues.

The Adviser will generally approve these proposals as shareholders can later divulge their votes to management on a selective basis if a legitimate reason arises.

6. Limiting directors' liability
7. Eliminate preemptive right

Preemptive rights give current shareholders the opportunity to maintain their current percentage ownership through any subsequent equity offerings. These provisions are no longer common in the U.S., and can restrict management's ability to raise new capital.

The Adviser generally approves the elimination of preemptive rights, but will oppose the elimination of limited preemptive rights, *e.g.*, on proposed issues representing more than an acceptable level of total dilution.

8. Employee Stock Purchase Plan

9. Establish 401(k) Plan

**C. Case-By-Case**

The Adviser will review each issue in this category on a case-by-case basis. Voting decisions will be made based on the financial interest of the fund. These matters include:

1. Pay directors solely in stocks

2. Eliminate director mandatory retirement policy

3. Rotate annual meeting location/date

4. Option and stock grants to management and directors

5. Allowing indemnification of directors and/or officers after reviewing the applicable laws and extent of protection requested.