

THE LONDON COMPANY

INVESTMENT COUNSEL

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As we enter our 11th year of operations, we are pleased to be recognized as one of the leading performing equity managers for the past ten years (Nelson Marketplace, Thomson Financial, August 2005). However, we are more proud of how we got there ... with extremely low volatility and downside protection, as evident by our *Lipper Leader* recognition for **Capital Preservation**.

NELSON MARKETPLACE		THOMSON		
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Product/Style Category:		U.S. Large Cap Growth & Value Equity		
Performance Measurement Period:		40 Quarters Ending 06/30/2005		
Mean Return for this Category and Return:		11.12		
Ranking (Universe Size):		Top 20 (out of 80 composites/funds)		
Rank	Firm Name	Product Name	40-Quarter Annualized % Return	\$ Assets in Composite
19	THE LONDON COMPANY	Large Cap Core	12.32%	\$187.4 M
Source: Nelson Marketplace web site, http://www.nelsoninformation.com/wbmm/search.asp?op=acr&AssetClassId=WB16&crumb=0&NumQuarters=40&page2=1 (August 2005).				

It has not been a straight line (never is), with interim 2-3 year cycles of over- and under-performance. We felt pressure during the 1997-2000 period when tech stocks skyrocketed and, more recently, the energy/commodity/real estate craze that went into full gear (beginning in 2003). While investors rationalize the speculation with “this time, it’s different,” it usually isn’t; and the subsequent crashes humble us back to reality.

We position our portfolios on a gradual, sustainable path of consistent outperformance over 5-year rolling periods, trying to mitigate the volatility in-between. Our slow, tortoise-like approach to rational, **long-term** investing historically rewards our investors with high, risk-adjusted returns over full market cycles.

In the third quarter, the market continued to be fueled by energy/commodity/real estate speculation, exacerbated by hurricanes Katrina and Rita. The same pundits, who claimed tech stocks would appreciate forever back in ‘99, are now preaching the same sermon on energy. In our view, there is a reason that oil, coal, natural gas, and other basic materials are called “commodities”. They are undifferentiated products whose values constantly rise and fall, hostage to the cruel supply/demand dynamics of free markets. When prices rise, supply increases through the existing raw material or substitute alternative; and demand eventually falls. Then prices fall, supply shrinks, and the cycle begins again with the result being a “zero sum” economic transaction. That is why

businesses spend so much of their time and capital trying to “de-commoditize” or brand their products. Basic economic laws don’t change. This time, it isn’t any different. Valuations do matter, and commodity prices will fall again.

Well, enough for being on a “soap box”. We have just heard too many Jim Cramer’s out there, “pumping” the same investment hype that they pushed five years ago on tech. There is a reason the English words “commodity” and “commode” come from the same Latin root.

Where are we today? As we enter our third year of an inflationary cycle, the Federal Reserve has made it clear they intend to halt the inflationary forces with a +300 basis point increase in short rates in a relatively short period of time, thus flirting with an **inverted yield curve**. If there is one reliable means of predicting a recession, the inverted yield curve will surpass any economist over time. If not a recession, certainly a major slowdown which would lead investors back to the quality, large cap consumer staples, financials, and healthcare sectors.

Why? Because the very factors that aggressive monetary stimulus and a sharp yield curve promote in terms of growth, speculation, and leverage, reverse in periods of a restrictive monetary policy, creating contraction in leverage, expansion, and pricing in cyclicals and commodities. During periods of contraction, investors become less confident and shift to safer sectors that are not as prone to economic pressures.

We believe your portfolio is well positioned for the upcoming environment. Mega cap, global consumer companies, and financials have not participated in the market rally of the past three years, with many trading at their lowest valuations of the past decade or more. In addition, they are in extremely healthy financial shape, perhaps too healthy with an abundance of cash hoarding and virtually no debt. Many of our overcapitalized holdings could easily lower their cost of capital by 200 basis points or more through recapitalization of their balance sheets with low cost debt and the immediate payout of 20%-50% returns of excess capital. While we have seen “trickling” returns of this excess capital through increased dividend payouts, the opportunity for value enhancement through more significant balance sheet optimization is enormous, and we expect it will accelerate through increased pressure from shareholders, as well as the abundance of aggressive, private capital/hedge funds seeking return. Welcome back to the ‘80s (e.g., RJR, Gillette, KKR, hostile takeovers, LBOs).

We were even frustrated (or maybe “foolish” is a better word) enough to directly correspond with Mr. Buffett, Chairman of our largest holding (BRK), who is sitting on \$45 billion in cash and drowning with well over \$100 million of free cash flow production per week. His response was cordial, with the reasoning he would personally be competing with Berkshire Hathaway in terms of personally investing any special dividend payout. However, we suspect he is feeling the pressure to adhere to his well-documented owner principle of “creating a dollar of market value for every dollar retained over a 5-year rolling period”. Currently, he is about \$10,000/share behind, as we enter the 4th quarter of the fifth year. There has been only one period in the history of BRK where he temporarily failed to meet his 5-year test when, in early 2000, he quickly honored his guideline with his

first ever offer to buy back shares. That was at \$45,000/share - just about the same time the tech bubble peaked and crashed. Berkshire Hathaway then shot to \$90,000 over the next few years. Let's hope in the words of Yogi Berra, it is "déjà vu all over again".

Please feel free to call if you have any questions and/or would like to meet to discuss your portfolio. The London Company also offers the availability of its Advisors Code of Ethics, should you wish to review it. We thank you for your continued loyalty and trust.

Best regards,

A handwritten signature in black ink, appearing to read "Stephen M. Goddard". The signature is fluid and cursive, with a prominent initial "S" and a long, sweeping underline.

Stephen M. Goddard, CFA

SMG:mwm