

# THE LONDON COMPANY

## INVESTMENT COUNSEL

Stephen M. Goddard, CFA  
Managing Director

One James Center, Suite 1501  
Richmond, Virginia 23219

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

October 20, 2006

Your portfolio performed well in the third quarter of 2006, as it continued to benefit from the market trend to higher quality, lower risk companies. We believe this recent shift is just the beginning of a long-term cycle, as depressed valuations of “megacap” blue chips, financials, and lower beta staples converge toward the cyclical market leaders of the past five years.

The stock market rally that began in July continued through September, producing the best performing third quarter in nine years and one of the few positive returning Septembers in memory. Most of the impetus for the gains came from weakening commodities, especially oil and gas. Cessation of rate hikes by the Federal Reserve also bolstered investor’s spirits. The third quarter strength in the markets has spilled over into October and year-to-date, the total return of the S&P 500 is more than 9%, a performance exceeding that of most hedge funds!

We have observed the first half of a classic market cycle with more cyclical and smaller companies leading the market out of the 2002-2003 recession. As we enter the more mature stages of an economic recovery with signs of slower growth, investors will move toward less speculative and more risk adverse positions in less economically sensitive “safe havens”. Large companies are seen as safe havens because, as compared to their smaller brethren, they have relatively visible earnings growth prospects even, if, as is likely, the economy’s growth slows down. These companies generate substantial excess capital which they are using to raise dividend payouts and to repurchase their shares. Their fundamental attraction is enhanced by their reasonable valuations, as most are trading at or below the market multiple even while they offer superior growth prospects. In particular, the consumer staples, healthcare, and financials sectors as well as “megacap” blue chips tend to outperform as the Fed ceases monetary tightening amid signs of slower economic growth and less inflationary pressures.

S&P 500 sector	% Gain 252 Days Later	% Batting Average (1974-2000)
Health Care	17.6	100
Consumer Staples	15.5	100
Financials	11.9	66.7

*Source: Ned Davis Research*

These three major sectors nearly always outperform after a Fed tightening cycle. Future market returns will be dictated by the direction of long-term interest rates. Advocates of rising long-term rates point to record deficits, continued inflationary pressures, and a relatively healthy economy as reasons why long-term rates will trend up.

Those who believe that long-term rates will decline emphasize recent signs of weakness in housing, falling energy prices, and tamed inflation.

Rather than debate which side has more merit, we prefer relying on the “collective wisdom” of the markets. Long-term interest rates are not controlled by the Fed or a global monetary authority, but rather the efficiency of a free market. The yield curve has been a far more reliable indicator of long-term interest rates and future growth of the economy than market forecasters. Long-term rates are currently at 4.75-4.80% and declining. Current long-term rates are lower than short term rates, a condition also known as an inverted yield curve. As shown in the chart below, inverted yield curves are a good predictor of slower economic growth.

<b>RECESSION WARNING FLAG</b>		
<b>Bond-to-Bill Yield Spread</b>		
	<u>Yield Spread</u> less than 0.5%	<u>Lead time</u> to recession
1	1968/04/07	20 mo
2	( 1973/04/14	7 mo )
	1973/06/16	5 mo )
3	1978/12/16	13 mo
4	1980/10/25	9 mo
5	1981/05/02	3 mo
6	( 1989/06/10	13 mo )
	1989/10/14	9 mo )
7	( 1998/09/12	- )
	1998/12/19	- )
8	( 2000/04/15	11 mo )
	2000/07/01	9 mo )
	2006/01/21	? currently 6 mo
<b>Avg: 9 mo</b>		
*10 yr T-bond yield minus 3 mo T-bill yield (4 consecutive weeks)		

*Source: Ned Davis Research*

History shows that inverted yield curves nearly always lead to a slowdown or recession. We do not think it is going to be different this time. Long-term rates and markets are clearly indicating slower growth, lower inflation, and falling interest rates.

This risk adverse, late cycle market environment has historically been ideal for our classic, conservative style. Sector emphasis in low beta consumer, financials, and non-commodity positions benefits us, as these sectors are generally recession resistant. We are confident of market outperformance over the next three to five years.

On a separate note, we are pleased to announce that on November 6, 2006, we will be moving to new offices. Our phone and facsimile numbers will remain the same. Our new address is shown below and on the attached card.

The London Company  
 1801 Bayberry Court, Suite 301  
 Richmond, Virginia 23226

October 20, 2006

Page 3

Please feel free to call if you would like to discuss this further. Thank you for your continued patience and loyalty.

Sincerely,



Stephen M. Goddard, CFA



A. Marshall Acuff, Jr., CFA



Jonathan T. Moody

SMG:AMA:JTM:rgt