

THE LONDON COMPANY

INVESTMENT COUNSEL

Stephen M. Goddard, CFA
Managing Director

1801 Bayberry Court, Suite 301
Richmond, Virginia 23226

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

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Dear Client,

Recent turmoil in the financial markets has increased. Recently, the Dow Jones Industrial average closed its worst one day drop, in terms of absolute points, in its history. Investors are rightfully nervous and are most likely asking themselves, "Where do we go from here?"

When we wrote our 2006 fourth quarter letter, we spent some time talking about how we thought the systemic risk related to the huge increase in securities tied to housing was being incorrectly priced in the market. At that time, investors seemed to care little about the risks inherent in these assets and as a result, many of these assets were priced too high and the financial institutions holding these securities were far too leveraged as they sought to take advantage of an easy money environment.

We are now seeing what comes from such incentives, combined with manipulative hedge fund trading practices. When we wrote that letter, we were optimistic on the other spectrum of corporate America that comprises 80 to 90 percent of the public marketplace, (industrials, consumer staples, non-lending financials, healthcare, etc.) reflecting the strongest balance sheets and cash flow generation in over two decades and the ability to utilize their underlevered balance sheets to enhance shareholder value through increase buybacks and dividends. Indeed, we still feel this way.

Today, we see a somewhat mirror image to what we saw in late 2006: risks are at the forefront of investor's minds due to the historic dislocation in fixed income and some securitized markets due to problems in a relatively small component (banks -10 percent) of the overall public marketplace. We did not see the extent to which relaxed regulation, abusive short selling practices and mark to market accounting would disrupt the market and remove the ability of major financial institutions to gradually work through problem assets, as they had in previous credit contractions.

So far in 2008, we have had seven major institutions fail or be forced into the arms of stronger partners due to a combination of the factors mentioned above. The result is a drying up of credit unlike we have seen in a very long time. Congress has finally woken up to this fact and after initially floundering, looks like it will pass legislation that will help ease credit market's concerns. Unfortunately, Congress has been slow to act and as a result, it now looks like the seizing of the credit markets will impact the real economy.

However, we continue to believe that we are closer to the end than we are to the beginning and we do see some signs for optimism.

Initial signs of housing stabilization: Housing has been the root of the problems. Once the housing market stabilizes, all the financial instruments built on top of mortgages can be clearly valued and the turmoil on financial institutions' balance sheets caused by mark-to-market accounting will subside. The most widely followed housing index is the S&P/Case-Shiller index and it is down some 20% below its peak, but its pace of decline is moderating. Housing inventory for sale has also been reduced for the first time in many years.

Excess capital and ample global liquidity: JP Morgan and Strategas point out there is a lot of liquidity waiting in the wings to be deployed in the markets around the Globe. Namely, \$3.5 trillion in U.S. Money market funds and \$2.2 trillion outside the U.S., not to mention the \$500 billion in private equity funds, oil-fed sovereign wealth funds, and Global saving accounts of \$35 trillion.

80 to 90 percent of public companies have stellar balance sheets: Corporate America's cash balances are at a 10-year high. Companies can use this cash to pay dividends, buy back stock, or expand their businesses via capital expenditures or acquiring other businesses. Public market valuations for many companies are significantly below private market, as has been demonstrated by recent acquisitions at 25 to 70 percent premiums.

Abusive short selling removed: We do not think it was a coincidence the markets rebounded when regulators placed temporary restrictions on manipulative naked short selling and resumed the decline again when the restrictions were lifted. The SEC has indicated they will be addressing the issue very shortly with more permanent rules to prevent manipulative trading practices.

Naked short selling has definitely been a factor in the demise of some of the financial institutions that have failed recently. Valuation of financial assets concerns itself mainly with confidence about future prospects of the firms in question. In the not too distant past, short selling had two governors that prevented it from overwhelming the system: the up-tick rule and a prohibition on shorting a stock without having first borrowed it, or so called naked short selling. We believe naked short selling is the more pernicious of these two lapses because it infinitely increases the supply of something that is, by its very nature, limited. A company has a limited amount of stock outstanding and if the supply is infinitely increased, as in the case of naked short selling, then the price of the stock will inevitably go down. The up-tick rule prevented short sellers from selling the stock without a buyers first paying up for it. This rule had the effect of preventing short sellers from driving the stock down without first having natural buyers pay up for the stock.

The net effect of both of these two issues is that it put short sellers in control and they could, and did, mercilessly drive the price of questionable institutions down which decreased confidence in those institutions by other market players. This created a self fulfilling prophecy and has contributed to the market's recent action.

Mark to market accounting has just fed the short sellers havoc because of what we mentioned earlier about no one really knowing what the mortgages underlying all the derivatives built on top of them are worth. Under current regulations, financial institutions have to mark these securitized assets to the quoted market value, even if the quoted value doesn't reflect the real value and in majority of cases are still performing. In these cases, the institution takes a major hit to its highly leveraged capital base and profit and loss statement. This adds to confusion of the institution's viability and in recent months, since all the marks have been negative, increases the panic in the marketplace.

At The London Company, we believe our portfolios are well positioned to weather this storm. The stocks we own are attractively priced and represent companies that are generating high returns on capital, with strong balance sheets, stable businesses, and great management teams that should be able to survive the current malaise.

We appreciate your continued faith and trust. Please call with any questions.

Best regards,



Stephen M. Goddard, CFA



Jonathan T. Moody



J. Wade Stinnette, Jr.