

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

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In 2005, stock market returns represented by the major indices were below the expected trend of 6% for the 2000-2010 period. For example, the S&P 500 returned 4.9% for the year, one-third of which came from dividends. The remarkable feature of last year's market was that stocks performed as well as they did. Of course, the energy sector was the stand-out performer. That was hardly surprising, given the rise of oil and gas prices. What was surprising was that stocks performed well in the face of rising energy prices and interest rates.

Why did stocks act relatively well? The explanation is simple. Revenues and profit margins grew faster than expected for the majority of corporate enterprises last year. Consequently, earnings on the upside and cash flow generation also exceeded expectations. With strong cash flow, the S&P 500 companies spent about \$315 billion on share buy-backs. This record amount spent for share purchases eclipsed the previous record of \$197 billion spent in 2004. With such a huge amount spent on share buy-backs, it is hardly surprising to find that a healthy increment of earnings growth came from this financial engineering. It is reasonable to estimate that without the buy-backs, S&P 500 profits would have grown in the high single-digits, not the 13%-14% gains expected to be reported for 2005. Such financial engineering is not the substance from which any rise in valuations can be sustained.

At The London Company, our analysis of companies focuses on cash flow growth and how it is valued. In the process, we pay attention to how excess capital is being deployed. Experience has taught us that companies, like governments, can make inefficient and wasteful uses of capital. Consequently, we are particularly sensitive at this time of excess capital generation about how cash flow is being allocated. Obviously, we like to see reinvestment in expansion where appropriate. We are less enthusiastic about the purchase of other companies and even significant expenditures on share repurchases.

While believing companies, especially those that are more mature in their growth curve, should return capital to stockholders, our preference is for capital to be returned directly to shareholders through consistent dividend growth. The equalization of the taxation of capital gains and dividends would seem to favor a greater focus on dividend growth. Good corporate governance supports investors getting increased dividends on the basis that cash flow is required to raise dividends, or put another way, you see what you get.

Fortunately, an increasing number of companies are using this excess capital to raise dividends. Standard & Poors counted 1,949 announcements of dividend increases last

year, a 12% increase from 2003. These dividend boosts increase the return of equities (note that one-third of the returns last year from the S&P 500 come from dividends), and also cushion the return of stocks during market setbacks.

Looking forward into 2006, we do not believe that revenues and profit margins will be better than expected as they were in 2005 for most companies. Nonetheless, cash flows should remain robust. While it's difficult to prognosticate share buy-backs, we can forecast continuing favorable dividend growth, despite the likelihood that corporate profits may grow less in 2006 than they did in 2005. We remain optimistic about dividend growth because the pay-out ratios of dividends to earnings for the S&P 500 is still about 30%, well below its historical norm of 45%. With more companies experiencing a structured slowdown in profits growth, it is likely that pay-outs will move higher in a setting of excess capital and fewer legitimate alternatives than in the past to put large sums to work in investments for new products, expansion, etc. Reinforcing this view of another year of strong dividend growth, Standards & Poors recently estimated that more than 2,000 dividend increases may be announced in 2006. Our investment strategy continues to place emphasis on those companies which can consistently raise dividends.

We thank you for your continued confidence. Should you have any questions or comments, please feel free to contact us.

Sincerely,



Stephen M. Goddard, CFA



A. Marshall Acuff, Jr., CFA

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