

THE LONDON COMPANY

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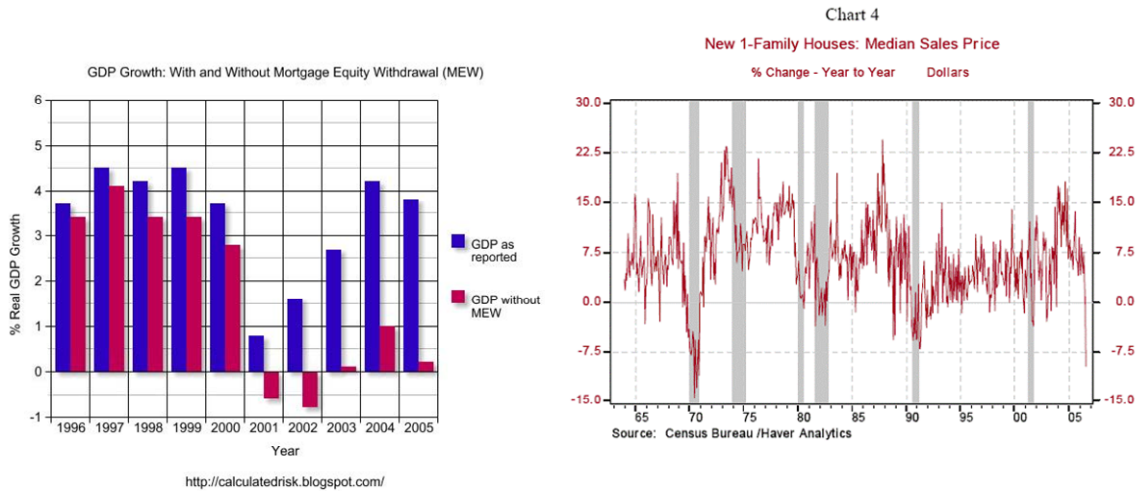
January 23, 2007

2006 proved to be good year for your portfolio as the strength seen throughout the first three quarters continued in the fourth quarter. We have been talking for some time about what we see as a “megatrend” in the investing climate, namely, that companies that have the ability to pay increasing dividends or otherwise return capital to shareholders would outperform the market. The performance we saw this year was consistent with this theme as our companies, for the most part, outperformed the market. Nevertheless, as we look into 2007, we do see some clouds on the horizon.

If we had to use one word to sum up the consensus view on the market as we enter 2007, it would be “complacent.” In the traditional media and most Wall Street research, we see a preponderance of bulls, or at least very little concern for risk. This in itself makes us take pause and take a closer look at our assumptions and how our portfolios are positioned as we move into 2007. There are three main concerns that we believe are perhaps underestimated by the market: continued fall out from the housing slowdown, the weakness in the dollar, and anecdotal signs that we take to mean that the economy is at least headed for a growth recession, if not an outright recession.

The slowdown in housing has been broadly described in the business press, and at first glance it is hard to believe that the effects have not been discounted in market prices. We believe that if the fallout were really being discounted in the market, market risk premiums would be higher than they are currently. Instead, they are at historical lows across many asset classes. Some of this is due to the technical factors of demand from foreign investors having to invest their money somewhere. This may continue for some time, but we believe risk is being incorrectly priced in the current environment.

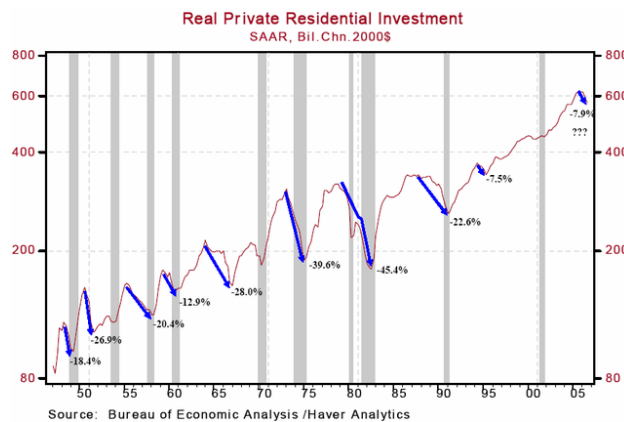
So, why are we so concerned about housing? The chart below on the left shows that spending from mortgage equity extractions has been an exceedingly large part of the recent growth in GDP.



The chart above on the right shows just how soft the real estate market is. When you consider that as a percent of equity, the decline is even more meaningful, we take this chart as evidence that the home's role as an ATM for consumer spending is effectively over. According to *Forbes* columnist, Gary Shilling, some 60% of subprime adjustable rate mortgages issued since 2004 have fixed interest rates for two years and can eventually adjust to over 6 percent higher than the current short term benchmark. Under the current environment, they could adjust to 11.4%.

It is not hard to create a dire scenario if we start to see forced liquidations of this real estate. This leads us to believe that it is probable that the current soft market in real estate will likely stay with us for some time.

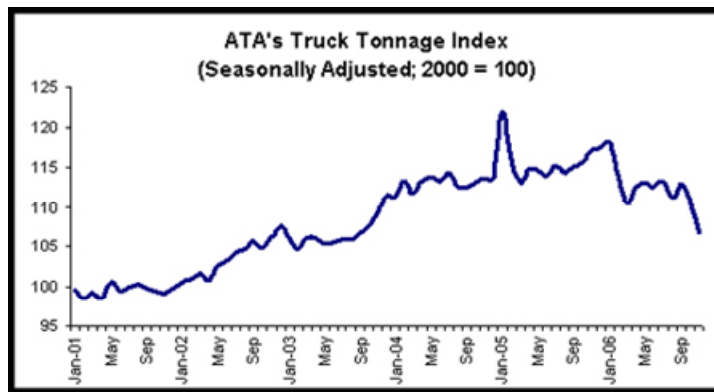
As shown in the chart below, consumers have already started to reign in their horns a bit in response to soft the housing market, but the real takeaway from this chart is that once these slowdowns start, they are not short lived.



The second item we are concerned with is the dollar. We believe the dollar presents a real Gordian knot for the Fed. If it eases, as the bond market seems to expect, the dollar

will likely fall further. A weak dollar may help U.S. exporters, but the holders of dollar denominated assets will be hurt and they could seek to reduce their dollar denominated holdings. This would likely see risk premiums return to more normal levels, but the implications for financial markets are not good. If the Fed maintains a tight monetary policy, it risks exacerbating any potential slowdown.

The third thing we are concerned with is really a group of data points that together point to a slowdown. These things include disappointing retail sales, signs that the consumer is getting overextended, and evidence from truckers and air freight carriers that the quantity of goods being transported in the economy is down significantly.



Source: American Trucking Association

Despite the aforementioned concerns, there is some reason to be optimistic. Corporate profit margins and balance sheets are both in great shape. In addition, there continues to be a large amount of money in private equity funds. Both of these factors should tend to reduce the supply of equity, either through merger and acquisition activity or stock buybacks, which should bode well for stock prices.

At The London Company, we search for companies that have excellent returns on capital, have very stable businesses, and generate predictable cash flows. These types of companies are the very type that private equity buyers are looking for and we are optimistic that our companies will outperform in the current environment.

We thank you for your continued confidence and trust. Please feel free to call with any questions or comments.

Sincerely,

Stephen M. Goddard, CFA

Jonathan T. Moody