

THE LONDON COMPANY

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“The more things change, the more they stay the same.”

-Alphonse Karr, 19th century French Novelist

To the clients and friends of The London Company:

Despite another turbulent year of unexpected events causing unnerving ebbs and flows in the equity markets, the end result is that it was all for naught. The S&P 500 ended the year practically where it began. After returning a respectable 11.8% in the fourth quarter, the S&P 500 finished 2011 up just 2.1%. Remove the dividends and the return was indiscernible at -0.003%. That's not implying the ride was smooth sailing. In fact, volatility was again severe and confidence remained stubbornly low. Small Caps did slightly better for the fourth quarter but slightly worse for the year, with the Russell 2000 index returning 15.5% and -4.2% respectively. Like the years of recent past, 2011 brought an array of issues that caused concern. The year began with the Arab Spring and subsequent political upheavals across North Africa and the Middle East. A disastrous earthquake and tsunami in Japan followed, as did an embarrassing display of ineptitude by our Congressional leaders during the debt ceiling debate. The result of the latter was the downgrading of the U.S. 'AAA' credit rating, which ironically did nothing but actually draw more assets to government paper. This only occurred because the problems abroad overshadowed our domestic concerns, specifically the sovereign credit crisis in Europe. All in, the events were random enough and spread out evenly that the only certainty in 2011 was constant uncertainty.

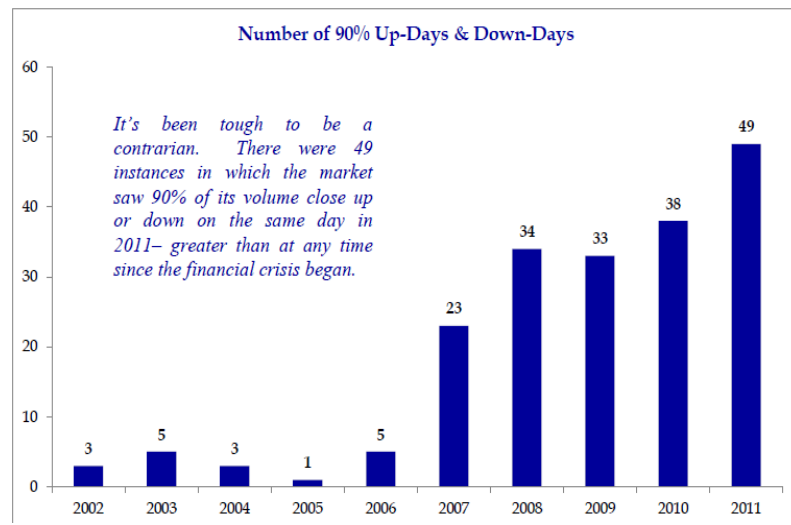
For U.S. investors, a positive although small return seems like a victory. Other major equity markets fared far worse in 2011 - producing an average decline of 15% among UK, Canada, Germany, France, Japan, Brazil and China. Risk aversion was paramount this year and investors gravitated to where they felt most secure. Amazingly, the 30-year Treasury beat out every stock in the Dow Jones Index, and Large Cap stocks led Midcaps which led Small Caps. The best performing assets were the most conservative, lower beta pockets of the market.

The London Company performed relatively well in 2011. Across all our strategies, we ended the year notably ahead of all the respective benchmarks. Positive stock selection continued through the fourth quarter and enabled us to gain further ground on the indices despite the seasonal year-end rally. Specifically, we benefitted greatly from our top

weighted positions performing well and meaningfully contributing to returns. The risk-averse environment was a welcome tailwind and a reversion from the year prior, benefitting our conservative, lower-beta portfolios.

Within large caps, the best performing sectors of the S&P 500 were the traditionally defensive Utilities, Consumer Staples, and Health Care sectors. The three worst S&P 500 sectors, and the only negative sectors despite the meager 2.1% return for the entire index, were Financials, Materials, and Industrials. In small cap, the Russell 2000 was similar with the same three top-performing sectors aiding the most during the year. The only difference was that those three sectors posted the only positive returns; the remaining sectors were in negative territory and led by Materials, Energy, and Technology. From a portfolio construction viewpoint, the aforementioned heightened volatility allowed us to add to our highest conviction holdings during periods of distress. Abrupt market dislocations tend to favor our long-term time horizon.

The chart to the right shows the extreme equity correlation over the past few years and the difficulty of outperforming the index. Equity correlations have repeatedly tested the 50-year highs and remain two standard deviations above the historical mean, but the actual number of days in which 90% or more of the market moves in the same direction is exceptional. The past few



Source: Strategas

years have been difficult for over-diversified and index-hugging managers, making it nearly impossible to separate returns from this market force. The 'risk-on, risk-off' crowd is creating an environment that perpetually removes confidence from the system. Compared to 2002 - 2006, it is easy to see how investor sentiment has become frustrated with the constant fluctuations and lack of visibility over the past five years. Market timing has always been a difficult way to make a living, but maybe never more challenging than today. Symbolizing perhaps a peak of this phenomenon is the introduction of exchange traded funds (ETFs) to trade volatility. The ETRACS Fisher-Gartman Risk On (ticker: ONN) and the ETRACS Fisher-Gartman Risk Off (Ticker: OFF) ETF will now be a way to trade risk. ETFs have advantages and disadvantages but actually attempting to take a market byproduct and turn it into an asset class is beyond bizarre. This further validates our belief that to beat the index you have to be substantially different than the index, a core tenet in our investment philosophy.

Another core tenet is to remain fully invested at all times. This past October was the single best month for stocks in the past quarter century, and the best on record for our

small cap product. September 2010 was the best 'September' on record in 71 years for stocks overall. Returns are inherently concentrated and vary more monthly when volatility is excessive, so predicting the wild swings of the market is futile. If you exclude just the top ten performing months of the past 20 years in the stock market, you reduce the cumulative return by over 60%. The annualized return of the S&P 500 since 1992 is 5.8%, and just 1.4% without those top ten months. Now granted, repeating this practice for the bottom ten months also produces opposite yet similar discrepancies in returns, exemplifying the importance of our most valued core tenet at The London Company, which is to focus more on downside protection than potential gains. We believe that the market is much less efficient at assessing risk than reward, and that eliminating potential disasters is vital to producing sustainable above-average returns. Over time, we have added value by staying fully invested and having a disciplined process to preserve capital.

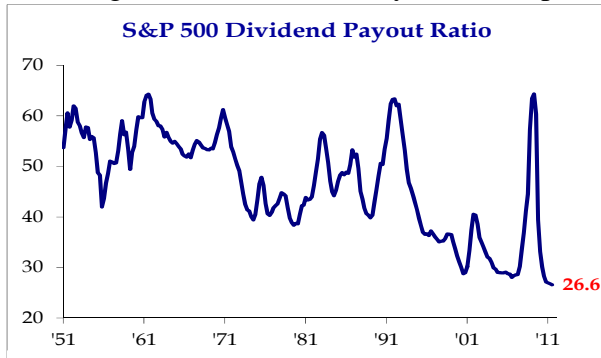
Looking ahead, we fully anticipate 2012 will be dominated by the Presidential election. All of the domestic issues will be debated ad nauseam with little resolution until 2013 or later. The benefit of the debt ceiling debate last year was the mere fact that the conversation finally shifted to the long-term structural imbalances of our debt addiction. And while the *super committee* still failed to reach an agreement, the attention it gathered will make it difficult to continually kick it down the proverbial road. Furthermore, the credit issues stressing Europe provide a prescient picture of our fate if we lose the fortitude to address it. European credit has dominated headlines the last few months and the issues across the pond are critical enough to warrant our full attention. The magical elixir to all these problems is growth, which unfortunately is difficult to muster up these days.

Global deleveraging takes time and the run up of consumer debt in America and government sponsored debt in Europe has contracted credit and reduced growth. The painful process of paying the bill is a necessary step before global GDP growth can resume. This conundrum is why there is no easy solution and why uncertainty prevails. Every summit and every concession gets closer to a rational and orderly handling of the crisis, a wish all investors have around the globe.

In America, fears of contagion are joined by our frustration of a slowly recovering economy. Uncertainty of how we will handle the budget deficits and long-term debt burdens weigh on the psyche. Tax and regulation uncertainty continue to have a negative influence on job creation, as does persistently low consumer demand and confidence. Nevertheless, we believe these issues are temporary in nature and already discounted in valuations. Any visibility or improvement to any of the above may bode well for the equity markets.

Corporations continue to perform well in a tough environment. Productivity gains and earnings growth have surpassed expectations most of the year. In our portfolios, we have witnessed capable managers adjust quickly to changing market dynamics and deliver solid returns on capital. Organic top-line growth is subdued, but we have benefitted from a handful of businesses finding growth in emerging markets. Cash balances are still accumulating and have reached record highs as a percentage of total assets. Stock

repurchases have increased nicely from 2010 and dividend increases are gradually occurring. The demand for yield has spiked and investors are seeking income from



Source: Strategas

stocks given the low rates in cash markets and bonds. While corporate profits have expanded the dividend payout ratio has decreased. As seen in the chart to the left, the 26.6% payout ratio is the lowest in 60 years. The ability of management teams to grow the dividend will come with increased confidence and clarity to many of the issues we have already addressed. The uncertainty and excessive volatility also

affected M&A activity. One of the surprises in the second half of 2011 was the decline in acquisitions and private equity deals. The deals that were announced give support to valuations and are often instantly accretive. The low cost of debt should help reaccelerate this trend as long as purchasers and sellers feel confident about the environment.

In conclusion, we don't have a great answer to how everything will play out in 2012. The consensus forecast calls for mild GDP growth and a mild European recession. The reality is no one has a clue, and these 'forecasts' are just the best we have to go by. So what do you do? You control things you can and worry less about the things you cannot. We focus on the companies we know and the managements we feel are the most capable of navigating turbulent waters. Understanding the true intrinsic value of businesses offers downside protection when markets fall and investing in companies with competitive advantages and high returns on capital helps keep pace when markets rise.

Current equity valuations are compelling and the risk of waiting for the skies to clear appears great. Our investment horizon looks beyond the near-term uncertainty and finds future returns for equities to be favorable. We expect volatility to stay elevated and the market to benefit managers that differentiate themselves from the index. The London Company has historically done well in uneven markets and periods of distress. If 2012 repeats the pattern of the last few years, we should perform well in relation to the benchmarks. Thank you again for your trust and support, and please feel free to contact us with any questions or concerns.

Best regards,

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Important Disclosures:

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