THE LONDON COMPANY

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To the clients and friends of The London Company:

First quarter equity returns were incredibly strong, continuing last year's fourth quarter rally and further boosting investor confidence. The 12.59% quarterly return for the S&P 500 is the best 'first quarter' in a decade and the 12.44% quarterly return for the Russell 2000 Index confirms that the rally extended across all capitalization ranges.

The market was strong from the first day of January and never looked back. Those waiting to 'buy on the dip' are still waiting, while those of us who stay fully invested participated nicely. The more cyclical, higher beta segments of the market led the way. The bulk of the gains were in the cyclical Technology, Consumer Discretionary, and Financial sectors, a reversal from 2011. Unsurprisingly, defensive sectors Consumer Staples, Utilities, and Energy trailed the market this quarter.

With our 'Defense First' investing philosophy, we expect to lag when markets appreciate sharply, let alone in a quarter that rockets upward at an annualized rate of 60%. This is especially true when the results for higher quality, high ROC (return on capital) companies trail those of lower quality, low ROC companies, as they have for these three months. So we are delighted that our Small Cap strategy kept pace with the Russell 2000 this quarter. Our Larger Cap strategies earned solid returns but, as expected, trailed the broader indices.

While the market recovery is still ongoing, it has not always been smooth or even self-supporting. The brutal truth is that we don't know much about its sustainability due to the high level of Federal Reserve intervention. It has been three years since the banking crisis nearly collapsed the world financial system. It is easy now to look back at that ominous intraday low of 666 on the S&P 500 in March 2009 and see it as a once-in-a-generation opportunity to buy risk assets. However, absent the Federal Reserve's dramatic, massive, resolute actions would the outcome have been the same?

The brave souls who stayed the course in equities have been rewarded, with market levels now close to prerecession highs. The S&P 500 has more than doubled from its March 2009 bottom, granting relief and fostering hope that the close call will not be repeated. The

small cap Russell 2000 Index has recovered its losses as well, up over 130% since the same market low and modestly outpacing the S&P 500. A handsome portion of the market return has come in just the last six months, as equities have appreciated by 25% since October.

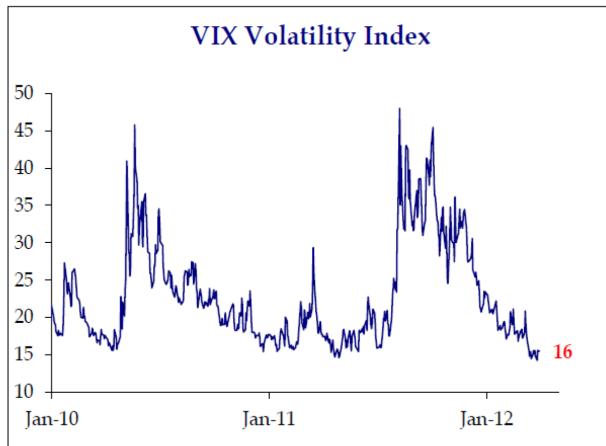
With regard to Fed intervention, look at the chart below and note the market action during both the QE-on (quantitative easing) and QE-off periods. The printing of money has many effects, but one of the most immediate and reliable is the subsequent correlation to higher equity returns. Following the success of QE1 and QE2, the latest installment has worked as advertised to enhance stock prices. Fortunately, Operation Twist has also been supported by improving economic data, particularly on the job front.

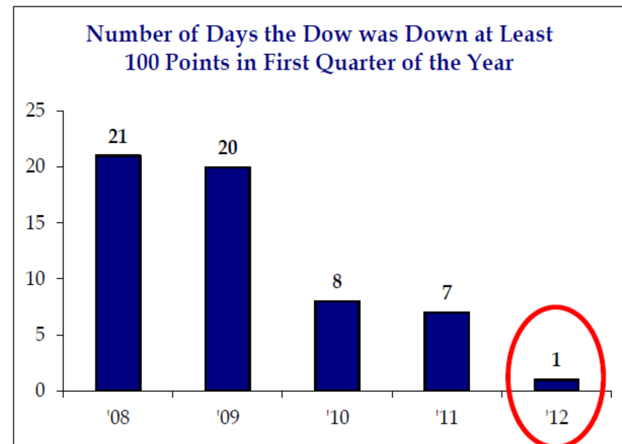
Source: Strategas

There is enough economic improvement to conclude things are heading in the right direction. Corporate earnings are robust and job claims have fallen considerably since their peak. There have been 3.5 million people added to the workforce over the past two years, slowly reducing the unemployment rate to 8.3%. Business and consumer confidence are escalating and a changing of the guard in Europe has eased, or at least delayed, immediate concerns over funding of sovereign deficits.

Further validation of an improving economic landscape can be seen in the bond market. 10-year Treasury yields traded below 2% for much of the time that Operation Twist was active but in late March popped up to 2.4%, indicating that an *untwisting* of yields may be occurring.[1] A modest uptick in interest rates is welcome if it signals improving loan demand in an expanding economy. However, a large increase could quickly become a headwind to our credit dependent recovery and add to the costs of servicing our enormous national debt burden. Preventing this consequence would require further monetary accommodation, acting as a backstop for the equity markets. Ignoring long-term consequences, investors' focus on short-term gains appears to be carrying the day. This will last until it doesn't… but predicting the future is as pointless as fighting the Fed.

An interesting characteristic of the recent market rally has been the relative calm of day-to-day trading since the start of the year. Volatility has become a market staple over the past few years, so a composed, steady rise up in stock prices is almost unsettling. The past three months have been almost devoid of volatility, as seen in the charts below. The Volatility Index (VIX) is near its two year low and the Dow Jones Industrial Index was down by 100+ points on only one day in the first quarter, a remarkable display of complacency.

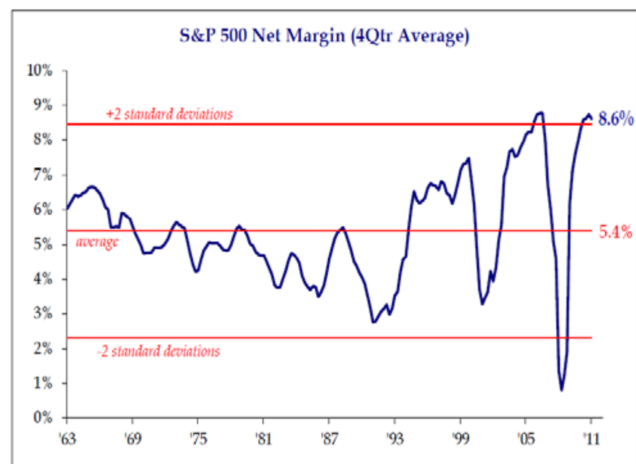




Source: Strategas

This historically low market volatility is occurring at the end of an extraordinary three year run that was just topped off by one of the best quarterly returns in a decade. Equity markets are inherently volatile and a sense of contentment among investors following such outsized gains can persist for a time but invariably ends in tears. The steady first quarter has been credited to the aforementioned economic improvements, and to the absence of any global shock. While gas prices are reaching $4 per gallon and could be an issue this summer, there was no Arab Spring, disastrous Tsunami, or political dysfunction this quarter (at least not any of abnormal magnitude) to derail investor optimism.

This bull market has been built on a dual foundation of Fed liquidity and the exceptional profitability of Corporate America. Across all industries, companies are producing more with less. While this inhibits job growth, it has increased earnings growth and cash flow. Corporate per share earnings are up nearly 95% since the market bottom while per share revenues are up only 1%.[2] This level of disparity is unsustainable. It has resulted in record profit margins (see chart on right), which historically are mean reverting. Peak margins may be able to carry-on at higher levels for as long as management teams sit on excess cash and delay capital spending. Investment and employment growth is still being restrained by uncertainty on taxes, healthcare costs, and other regulatory



Source: Strategas

risks. Many of these issues are gaining clarity, but likely won't be resolved until the November election. With profit margins peaking and revenue growth hard to come by, managements are seeking alternate routes to value creation. We are big fans of executives and boards who think like owners in trying to enhance shareholder returns.

One of the most prevalent actions of late has been a surge in companies initiating divestitures and spin-offs. These transactions typically create shareholder value by reducing the conglomerate discount and allowing new companies easier access to capital to grow the business. From Alexander & Baldwin to Pfizer to MeadWestvaco to ConocoPhillips, there are numerous examples among our portfolio companies of management teams acting in our best interests to create more tightly focused companies.

The relative valuations of many of our companies are supported by private market transactions as well as strong balance sheets. The flexibility of companies to create value for shareholders is still great. We have discussed in previous letters the large amount of cash sitting in company coffers, but much of it has been earned and is being held outside of the US. An estimated $1.2 trillion is parked in subsidiaries of U.S. companies around the globe.[3] The money could be used to build factories and pay wages in the U.S. as well as pay dividends and repurchase stock, except that the simple act of wiring the money to the home office incurs a tax obligation approaching 50% payable to Federal and State agencies.

If you were the CEO of a multinational earning $100 million a year in Asia and your choice is to reinvest the entire amount in new plants and workers in Asia or to give half to the IRS and invest the other half in new plants and workers in the U.S., what would your decision be? Exactly. Tax policy is sure to become an increasingly heated topic in the run-up to the election.

The outlook is favorable considering the challenges we faced three years ago. Economic data is strengthening, corporate America is in relatively good health, volatility has been temporarily subdued, and the better management teams are recognizing opportunities to create value for shareholders. Despite a doubling of the market in the past three years, flows into equities by retail investors are non-existent. Over this period there has been roughly a $1 trillion inflow into bond funds at the expense of stock mutual funds, even though 1-in-6 companies that pay a dividend currently offer a higher yield on their stock than their bonds.

Yogi Berra said it best: "Making predictions is very hard, especially about the future." We will continue to focus on what we can control and worry less about what we cannot. We believe this environment is favorable to active managers who can uncover predictable, highly profitable business models that have limited downside risk. 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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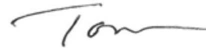

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[1] Yardeni Research – 3/19/2012
[2] Strategas – 3/20/2012
[3] Next Inning Technology Research – 3/26/2012

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