THE LONDON COMPANY

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To the clients and friends of The London Company:

During the first quarter, equity markets transitioned from resilient to resurgent. Impressive double-digit gains were posted across the capitalization spectrum, punctuated by the S&P 500 Index reaching an all-time record high on the last trading day of March. As if abiding by the proverbial principle, "see no evil, hear no evil", stocks have turned blind and deaf to the ever-present macro concerns. That omnipresent *wall of worry* appears small in scale these days as we have passed many of the most worrisome hurdles (e.g., Presidential election, fiscal cliff, sequestration, etc…). With policy aid in full gear both domestically and abroad, global central bankers have reduced fear and, at least for now, instilled confidence that everything is under control.

Equity returns in early 2013 support that thesis as the S&P 500 Index returned 10.6% and the Russell 2000 Small Cap Index returned 12.4%. The strength was broad based with all sectors posting positive returns. For the S&P 500, it was surprising to have the best performing sectors be Health Care, Consumer Staples, and Utilities. It is odd to have such a strong quarter be led by the more defensive-oriented segments of the market. In a reversal from last quarter, this most recent rally was of higher quality as indicated by lower beta stocks outperforming higher beta stocks - a favorable tailwind for our portfolios. The worst performing sectors, and the only three returning less than 10%, were Technology, Materials, and Telecom. For the Russell 2000, the returns were even more equally distributed with just 5% dispersion from the best sector to the worst. Leading the way were Health Care, Industrials, and Financials. Trailing the index just slightly were Materials, Technology, and Consumer Staples. The returns sorted by beta were not as linear in the small cap universe as all beta quintiles were within a percentage point of each other.

The London Company performed well this quarter, both on an absolute and relative basis. All strategies ended ahead or right on top their benchmarks, and the Small Cap, Small-Mid, and Mid Cap products performed particularly well. Stock selection was positive across all disciplines and our portfolio construction enabled strong-performing positions to add significant value. In our Large Cap portfolios, select holdings in Financials, Technology, and Health Care were positive and contributed to results. This more than offset our negative sector allocation, specifically our underweight in Health Care and overweight in Materials. In our Small and Mid Cap portfolios, stock selection was the

biggest driver and our holdings in Health Care, Consumer Discretionary, Financials, and Technology had the largest contributions to performance. Sector allocation was more or less neutral and had no meaningful effect.

This strong quarter illustrates the perils of market timing and the benefits of our discipline to remain fully invested at all times. The last nine months have resulted in excellent equity returns despite the uncharted waters we faced along the way. Going back further to the market bottom four years ago, the S&P 500 is now up 132% - a victory for the faithful.* The timid that lost faith in equities and allocated assets on assumed safety and certainty (i.e., cash and treasury bonds) have not fared as well (*see table below*).

Annual Returns on Investments in			
Year	*S&P 500*	*3-month T.Bill*	*10-year T. Bond*
2009	26.5%	0.1%	-11.1%
2010	15.1%	0.1%	8.5%
2011	2.1%	0.0%	16.0%
2012	16.0%	0.1%	3.0%
Average	**14.6%**	**0.1%**	**3.6%**

Source: Stern, NYU, Bloomberg

First quarter returns this year mimic more of the same between stocks and bonds. While the new S&P 500 record high may or may not hold for the time being, a prediction we would never make, the reminder is that entering and exiting the market based on the reading of tea-leaves requires more luck than skill. Having a longer-term time horizon helps avoid such speculation; yet, market gyrations will always test the verve of the most disciplined professionals. The London Company removes this doubt by keeping our cash allocation to a minimal level. As long-term investors, we have never accepted volatility as an adequate measure of risk, rather focusing on the permanent loss of capital as our primary concern. Fortunately, our entire investment philosophy and process is geared toward downside protection, so when fear and panic is raging and sellers outnumber buyers we aim to absorb less of the downside.

At its core, investing of any sort requires overcoming some level of uncertainty, an actuality we have faced plenty of the last few years. To quote Jason Zweig's postscript commentary in Benjamin Graham's *The Intelligent Investor*, "…investors have never liked uncertainty – and yet it is the most fundamental and enduring condition of the investing world. It always has been, and always will be." Jason's commentary further labels "uncertainty" and "investing" as synonyms and states, "Without a saving faith in the future, no one would ever invest at all." We agree with this notion and acknowledge that investors typically believe tomorrow will be better than today.

Unfortunately, just believing in a better future doesn't yield investment success. The current gains of the market have been achieved by increased clarity but also by tangible fundamental improvements. Simply put, Corporate America is doing well and operating

profits are 13% higher than their pre-crisis peak. Leverage among the S&P 500 companies has been cut in half and historically low interest rates are slowly shifting assets into equities for income and capital appreciation. Free cash flow yields are at 50-year highs and the allocation of capital back to shareholders through dividends and stock repurchases continues to grow. The aforementioned help from the Federal Reserve also creates a favorable investment environment. When easy monetary policy is both vast and transparent it removes the typical ambiguity associated with Fed policy. Furthermore, central bankers around the world are now reading from the same playbook, and many global investors still portray the U.S. as the best house in a bad neighborhood.

On the negative side, organic growth is stagnant both domestically and abroad. First quarter Global GDP estimates are a meek 2.5%. Capital allocation, while improving, has a long way to go. The S&P 500 dividend payout ratio is still near its 60-year low at just 32%, and corporate balance sheets remain bloated with record high cash balances. This quarter saw a vocal activist (David Einhorn) push Apple to part with a token of their $137bn treasure chest through a perpetual preferred. This proposed preferred stock (smartly named iPref) would pay a continuous, above average dividend yield and is an ingenious alternative to take advantage of the significantly wide spread between the cost of debt and cost of equity. Referred to as the equity risk premium, today's artificially low interest rates create many attractive opportunities that have rarely existed in the past.

In a slow growth world with incredibly low interest rates, efficient capital allocation will be vital to maximizing wealth. The valuation levels of companies are being influenced by whether management teams *part with* or *hoard* cash. According to Empirical Research, large-cap stocks with favorable capital use profiles have outperformed the market over the last 10 years by more than 4 percentage points per annum, and those with the worst profiles have lagged by a like amount. As an example, a company growing just 2% but paying a 3% dividend and repurchasing 4% of its stock per year could earn a favorable return of 9%, holding all else constant. Given the cash on hand, ample free cash flow and flexibility to raise the payout ratio and repurchase shares, we expect this to be a long-term tailwind for equities, especially considering the very few options for income available elsewhere.

It is somewhat ironic that many of the large-cap names that shunned dividends 10-plus years ago are now embracing the notion to increase their dividends today. What was once seen as a sign of weakness is now a sign of strength. Wisely, investors are paying more for companies that optimize their capital structure to the benefit of shareholders. Historically, these actions have been contagious and when one company acts others begin to follow. Identifying the management teams that behave and think like long-term business owners is a vital part of our process.

The other outlet for capital allocation is M&A activity and leveraged buyouts. While we have been surprised by the slow uptake of deals, the transactions being completed are often instantly accretive, expressed by the unusual accompaniment of both the acquired and acquirer appreciating on the announcement. The actual number and volume of deals is slowly increasing, but considering the $1.6 trillion raised by private equity during the 2005-2007 period alone, of which more than a third is unused, the 'use it, or lose it'

provisions may spur increased activity going forward. Another positive development is the lack of shares being issued to finance transactions. Since 2008, cash is funding two-thirds of the deals, compared to one-third historically. A more disciplined buyer keeps prices honest and interests aligned with shareholders.

The few companies that have taken advantage of borrowing debt at low rates to repurchase their own stock are being rewarded as well. This slow approach to taking your company private should continue. A recent article in *USA Today* titled, "Investors face a shrinking supply of stock", notes that the 3,678 companies listed today in the Wilshire 5000 – a proxy for all U.S. based stocks – is less than half its 1998 peak and just a few hundred more than what was available in 1971. Despite tepid M&A activity the last couple years, it pales in comparison to the dearth of new IPO's and start-ups. If demand outstrips supply, and/or larger companies continue to grow at the expense of fewer competitors, prices paid for such names and margins generated could still have a ways to go.

Longer-term, we believe the over-arching landscape for equities remains favorable. When market sentiment changes in the short-term and uncertainty reappears, it offers us opportunities to actively select superior companies with shareholder-oriented management teams. By avoiding speculation and having a tangible sense of real risk, we remain optimistic in our ability to earn above average returns.

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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