THE
LONDON
COMPANY

April 5, 2017

To clients and friends of The London Company:

"Nowadays people know the price of everything and the value of nothing."

- *Oscar Wilde*

Here at The London Company, we are in the profession of determining value. Specifically, what an asset or business is truly worth. Sometimes that analysis aligns with the price of said asset or business and sometimes it doesn't. Our objective is to discover that disconnect on a select few businesses and then allow ample time so the underpriced asset, with the guidance from a capable management team, can converge to its true value. For brevity sake, we will temporarily ignore the many variables (interest rates, inflation, GDP growth) that can influence valuations at any given point in time and just accept that the relationship to price is not a static measure. That said, our philosophy and process is conservative and is predicated on not being wrong more than being right, so we focus on downside risks and try to reduce speculation in our analysis. Needless to say, we are a skeptical bunch. Oscar Wilde's quote above defines a cynic - a characterization close to heart – and although not originally intended for 21st century finance, it can be applied to today's stock market given ever-growing examples of dispersion between price and value.

This quarter marks the 8th anniversary of the March 2009 market low. The S&P 500 has returned over 270% since then, yet many continue to question the validity of these returns and if they are warranted by economic realities. Does the current market price represent its true future value or is it overextended (spoiler alert: we are not going to try to answer that)? Regardless, we are in the midst of the second longest bull market in history and the universal sentiment towards this recovery has been one of caution and skepticism. Most nonbelievers question the impact that historically low interest rates and the Federal Reserve's quantitative easing programs have had on boosting equity prices. Our focus is on another market force that is beginning to have an impact that is equally as difficult to quantify. It is the massive shift towards passive investment strategies (low fee index funds) that is impacting trading and market liquidity due to its growing size and scale.

It is this changing dynamic that we have briefly mentioned in the last couple letters but will dive into more detail this go around. As an active manager (one that constructs portfolios different from the index), our admittedly biased opinion won't debate the advantages or disadvantages of passive management, but instead provide commentary on the potential effect it is having on the underlying securities and why our attention to these vehicles is becoming more necessary. Our main concern is dislocations they are having on the price of stocks and what impact these vehicles may have on equity prices when the markets eventually roll over. It has been a long time since we have had a big downturn and the structure of today's market is vastly different

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than it was a decade ago. We believe both active and passive investing strategies can coexist going forward, but before we discuss, let's briefly recap this past quarter and what has been driving this market higher.

For equities, the beat goes on. First quarter returns were positive, extending the strong uptrend post the Presidential election. The S&P 500 Index continued its steady climb during the quarter and returned 6.1%. It was the index's best performance since the fourth quarter of 2013. The Russell 2000 Small Cap Index lagged its large cap brethren but still increased 2.5%. The first two months of the year saw most of the market gains as optimism from proposed fiscal policies coincided with tangible improvements in the economy. Reports of higher inflation expectations and increased consumer confidence during the period supported the prospect of faster GDP growth. The market seemed to agree as the return profile this quarter was steady, and mostly void of day-to-day volatility. The Trump agenda (tax reform, energy and business deregulation, infrastructure spending, clarity on trade agreements, etc.) dominated the outlook and stoked investor expectations for newfound policies. This resulted in a docile upmarket until mid-March, when the GOP's failure to repeal and replace the Affordable Care Act cast doubt on Trump's ability to pass his other economic agenda items. This setback coincided with another 25 basis point rate hike by The Fed and a slight downtick in the ISM reading, a leading economic indicator. Altogether it caused a minor pause in the market's advance and subsequently the first one day 1% decline in the S&P since October. This broke a streak of 109 days without a small 1% pullback, a very long stretch but one suggesting that the path going forward is bright.

The London Company portfolios performed mostly as expected. Our Large Cap, Mid Cap and SMID strategies ended the quarter relatively close to their benchmarks. The Income Equity portfolio split its benchmarks, outpacing the Russell 1000 Value index but lagging the S&P 500. The Small Cap and Concentrated products trailed their respective indices by a larger degree. Sector allocation was mixed across all our strategies but particularly detracting in Small Cap. Stock selection was negative for most products except SMID. Market leadership was fairly consistent across the capitalization spectrum, with the Health Care and Technology sectors leading the way and the Energy, Telecom and Financials sectors lagging behind. Somewhat surprisingly, the two sectors with the most to gain from Trump policies (Financials and Industrials) actually underperformed this period. Growth outpaced value across all market cap segments while cyclicals outperformed defensive stocks everywhere except in the mid cap space. The strength in cyclicals was most notable in small caps. Overall, lower beta and higher quality assets fared best, a traditionally a good backdrop for our portfolios but not enough to offset the other mixed factors.

Another takeaway this quarter was the extremely low volatility experienced throughout the period. We already highlighted the 109 day streak, but additionally, we witnessed tremendous intraday stability as there were only 2 instances where the market traded up or down more than 1% within a single day. This is a very unusual occurrence and one that doesn't help active managers like us. Low volatility and high stock correlations are not favorable conditions for active management. It has not gone unnoticed that passive returns have bettered active funds during this bull market, including a couple of our own strategies failing to outperform the last few years. This has led to countless debates over which approach is superior and if and when these trends may revert. Again, our focus is on the changing guard of our industry and not

guessing the timeframe when one approach will lead the other. So let's start with some perspective on recent history and how this movement may be impacting all of us.

Passive investing, at its core, is simply purchasing an index for a guaranteed market return less fees. The first index fund was introduced by Vanguard in 1976 and in the course of forty years the industry has grown from nothing to roughly $2.8 trillion in assets. Today, roughly one-third of all managed assets are indexed. The hyper growth of passive investing and the utilization of ETFs (exchange traded funds) have exploded in popularity because they are effective and cheap. ETFs are like traditional index funds but can be traded daily like any other stock. Unlike mutual funds, which are priced only at the market close, ETFs are continuously priced and may or may not represent the net asset value at any given point in time. This daily liquidity provides investors, speculators, or other arbitrage players the ability to access the 'market' quickly and efficiently. Additionally, these funds can be tailored to track a certain sub segments, like REITs or gold miners, or certain factors like momentum or low-volatility. These latter offerings are often referred to as smart beta ETFs.

Most index funds and ETFs are market cap weighted, meaning the largest positions receive the bulk of passive assets. As new money comes in, the larger companies maintain their respective position weights relative to other index constituents based on size alone and not company-specific factors. This seems reasonable but can become a problem if passive assets grow so large that they crowd out active managers who can't arbitrage that distortion and reset the company's price to its true value. Today, passive owners control roughly 16% of the average large cap stock, a 7.5x increase in the past 15 years. The autopilot nature of passive ownership means future returns will continue to be influenced more by asset flows than by fundamentals. When does this become a major risk, or has it already? Although it is a small sample size, we witnessed an unusual occurrence in the Russell 2000 Index last year. During the third quarter of 2016, ETF inflows bid up many small cap stocks with questionable financial characteristics. If passive investors must own the index then they must own everything, even the full quarter of that benchmark that isn't profitable. This portion of the index actually contributed twice its weight to the total return that quarter, partially due to passive inflows.

The fact that active managers, both mutual funds and hedge funds, have struggled to outperform their benchmarks recently has led to further asset accumulation into passive vehicles. According to Merrill Lynch, there has been a $2 trillion swap from active funds to passive funds in the past 8 years (see left chart below). Fortunately, the performance of active managers has been traditionally cyclical and at present is sitting at a relative low point (see right chart below).

Barring a dramatic swing in performance for active funds, near-term trends in asset flows are unlikely to change. This could become a self-sustaining cycle where passive flows begets underperformance of active funds which begets more flows into passive which begets...you get the idea. Currently, there are over 2,000 ETF options from which to choose. Ironically, there are only 3,700 U.S. listed stocks publicly trading. The shrinking equity supply is real, as the number of listed securities has been cut in half the past 20 years. Consolidation and the lack of initial public offerings (IPO's) are mostly to blame. The result is less opportunity for differentiation if more investment vehicles are chasing the same ideas.

The growth of ETFs has already had a sizeable impact on trading and liquidity. Although ETFs control roughly one-fifth of equity assets, they account for roughly half of the daily trading volume. State Street's massive SPDR ETF (SPY) is 9% of the daily trading volume alone. Given their low cost and ease of use, these vehicles are heavily favored by high frequency traders and algorithms run by hedge funds. Annualized turnover of the average ETF is an astonishing 880% compared to 120% for the average stock. This rapid turnover is mostly driven by speculation on short-term factors and much different than The London Company's strategy to hold positions for an average of five years. Massive trading creates about $7.5 trillion in daily settlements, meaning market structure integrity is imperative. Fortunately, we have only experienced a handful of flash crashes (rapid, volatile drops in the market) since 2009 and none the last two years. It could be due to a better market structure or just generally light market volatility. It is unknown if the larger size of passive funds today will cause more of these instances when equity prices aren't so calm.

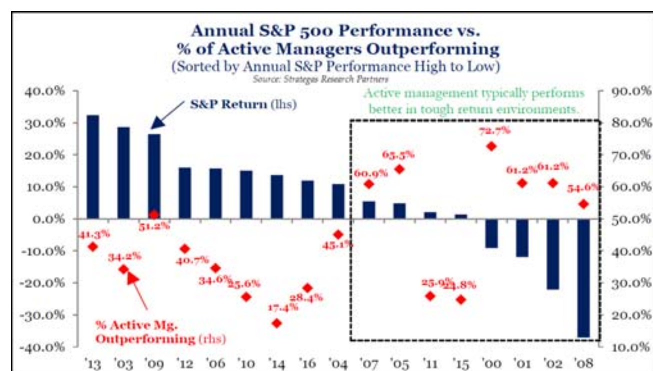
Another underappreciated risk is the concentration of the passive management industry. Despite the vast number of index options, the bulk of the assets are held in just a few hands. The industry is dominated by three behemoths: Vanguard, Blackrock and State Street. Together they account for 80% of all indexed assets, raising questions about their concentration. How do these passive owners influence corporate governance? Do they keep management teams honest and approach proxy matters with the same intensity as active managers? Do the trillions in assets these three large firms control present a risk to security prices if they find themselves in financial peril? Do their large products present market structure risk because of liquidity needs? Although The London Company currently has a position in one of these behemoths and we are comfortable with their current state, we tend to agree with Charlie Munger, vice chairman of Berkshire Hathaway who warned, "Index funds become permanent owners that can never sell. That will give them power they are not likely to use well."

Finally, the impact that passive ownership has on performance is becoming influential. Furey Research Partners recently demonstrated a strong, positive correlation between passive flows and stock performance in the Russell 2000 Small Cap Index. Beyond the earlier example of non-profitable stocks unjustifiably outperforming, simple increases in passive ownership is correlating to stronger returns. Over the past five years, companies that had an above average quarterly increase in passive ownership returned 14% on an annual basis. This is roughly double the 6% return of Russell 2000 stocks that had a below average quarterly increase in passive ownership. This discrepancy is large, and confirms that asset flows in and out of the index funds are unintentionally influencing true price discovery on these stocks.

Our friends at Empirical Research also studied market anomalies and discovered return distributions can be more volatile going forward on stocks with high passive ownership. Specifically, they found that the downside risk can be greater for positions that have high passive concentration. For example, 80% of REITs and 60% of Utilities rank in the highest quintile of passive ownership. These are common holdings of many low-volatility ETFs. There are over 30 such low-vol varieties, all clamoring around the same low beta stocks with high dividend yields. Once a thematic trade becomes too popular, conditions can change and the bubble bursts, causing monolithic selling. Tailored ETFs or smart beta offerings can distort supply and demand and alter the appropriate price of these stocks.

The impact to The London Company is that we are now more aware of the ownership levels in our stocks. High passive ownership is influencing performance more than the company fundamentals warrant and can be positive or negative depending on when flows are entering or exiting. It is important to know who owns these shares and why. Indiscriminate buying of small caps with poor fundamentals or thematic bets based on macro forecasts can influence short-term performance. The difficulty for active managers is that volatility and cross-sectional dispersion are needed to help offset these massive trends. The bull market of late is relatively stable with little dispersion of returns, so most sectors and stocks are moving in lockstep. Cross-sectional dispersion of the S&P 500 constituents is hovering near a 20-year low, and the correlation between top-quartile active funds and cross-sectional dispersion is strong. The co-movement of equities, in part due to passive flows, makes active outperformance more challenging. On a positive note, there are recent signs that correlations are lessening but it is too early to know if it will continue.

So, how does this evolve going forward? First, active managers need to outperform. Performance will dictate future flows into passive or active strategies. Active managers traditionally show their skill when markets are weak. The London Company's preferred perfomance environment is in flat to down markets. Our attention to downside protection is how we have earned most of our excess return. This past bull market has been favorable for passive funds due to strong returns, high equity correlations, and low inflation. Going forward, a different backdrop may not be so favorable to passive. Strategas Research Partners shows that active managers perform best in tough return environments (see left chart below) and when inflation expectations are increasing (see right chart below).



In the end, we feel both active and passive fit an investment need and can win going forward. We view passive investing just like any other technological evolution. New disruption is not always bad for an industry, but you must adapt to survive. We believe active managers need to

be really active, meaning very different from the index. ‘Closet indexing’ funds used to be one-fifth of active mutual funds but are losing share to more concentrated funds with less than 40 stocks. High active share, the reported number showing how different you are compared to a benchmark is key. The London Company strongly believes in being different and our active share numbers support that.

Looking ahead, we don’t know when trends will revert or when equity returns will decline. The same economic factors have not changed much. For example, world growth remains scarce despite recent signs of improvement. The U.S. has reported 11 straight years of less than 3% real GDP growth, the longest stretch since the Bureau of Economic Analysis started keeping track. Fortunately, there are visible signs of economic improvement and inflation expectations are rising. Fiscal policy changes from the oval office could also accelerate productivity and future GDP growth. In the meantime, we will continue to control what we can and be prepared for any economic backdrop. We are monitoring new market risks and looking for unintended consequences. The potential impact from passive management reiterates the importance of balance sheet strength going forward. If markets were to correct, companies with large debt burdens could be the first to suffer. The London Company prefers financial flexibility and companies that possess pricing power and tangible assets to support valuation. In closing, there is an old investment idiom that says markets will do whatever it takes to cause the most pain to the most number of people, so we take heed that this passive train may continue for some time, but we will not be along for the ride.

Thank you again for your trust and support, and please feel free to contact us with any questions or concerns.

Best regards,

The London Company

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